Lifetime Transfers to Nonresident Alien or Noncitizen Spouses: A Practical Solution to an Income and Gift Tax Problem

By
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Daniel S. Rubin offers a solution to the income and gift tax problem that arises upon a gift by a spouse to his or her nonresident alien or noncitizen spouse.

Introduction

Any first-year tax or matrimonial attorney should know that transfers to (or in trust for the benefit of) a spouse are generally protected under the Internal Revenue Code[1] against both federal income taxation,[2] in the case of a transfer of property in exchange for consideration in money or money's worth, and against federal gift taxation,[3] in the case of a gratuitous transfer of property.[4] The protection that is generally afforded from the federal income tax does not apply, however, in the case of a transfer by an individual to his or her spouse if such spouse is a nonresident alien.[5] Neither does the protection that is generally afforded from the federal gift tax apply in the case of a transfer by an individual to his or her spouse if such spouse is not a citizen of the United States[6]; moreover, it is significant that this is the case with regard to the federal gift tax irrespective of such noncitizen spouse's residence—whether it is within or without the United States. Therefore, in the case of both the federal income tax and the federal gift tax, a substantial tax trap exists for the unwary practitioner advising a client with a nonresident alien or noncitizen spouse.

From a public policy perspective, Congress did not deign to discriminate against individuals with nonresident alien or noncitizen spouses for any pejorative purpose. Instead, Congress only wanted to ensure that the transferred property

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would not forever escape taxation by the United States through a tax-free transfer of that property to an individual who is likely more ready, willing and able than a citizen of the United States might be to remove that property from the jurisdiction of the U.S. taxing authority.[7] In that Congress' concern in enacting the laws that discriminate against an individual with a nonresident alien or noncitizen spouse was in maintaining the integrity of the U.S. tax base, at least one practical solution to the problem at hand lies in ensuring that the property will remain subject to taxation by the United States notwithstanding the fact of its conveyance for the benefit of the nonresident alien or noncitizen spouse.[8] Such a result can be obtained by using a trust specifically designed to negate all of the adverse tax consequences to the transferor spouse while at the same time providing the recipient spouse with a close approximation of the privileges, immunities and protections that would have been afforded by an outright transfer if an outright transfer were feasible. A "grantor" type trust for the exclusive benefit of the nonresident alien or noncitizen spouse, the transfers to which are incomplete gifts by reason of a retained limited power of appointment in the grantor, can be crafted to provide this result. Such a trust might fairly be thought of as a non-statutory, *inter vivos* qualified domestic trust (QDOT).[9]

Discussion

An individual might desire to transfer property to his or her spouse for various reasons. As but one example (and with seemingly increasing prevalence), the transfer of property to a spouse might be incident to an ante-nuptial or post-nuptial agreement (collectively referred to herein as "marital agreements") in order that the parties might thereby define their relative rights and obligations in a more carefully tailored manner than would be the case under the public marriage contract. Typically, marital agreements contain waivers of support and property rights. In order to enhance the likelihood of the future enforceability of a waiver of support and property rights, consideration is frequently given in exchange for such waivers.

If both spouses are citizens of the United States, little thought need be given to the tax consequences attending the transfer of property pursuant to such marital agreements; to the extent that one spouse transfers property, other than cash, to the other spouse in exchange for such a waiver, Code Sec. 1041 will preclude the recognition of gain or loss in connection with such transferred property to the extent that such waivers are deemed to be consideration in money or money's worth received by the transferor spouse. Moreover, to the extent that the recipient spouse's waivers are not deemed to be full and adequate consideration in money or money's worth, the unlimited gift tax marital deduction of Code Sec. 2523(a) will shield such portion of the transfer from the federal gift tax.

Another common reason for the transfer of property by an individual to his or her spouse is so that the transferor spouse might evidence his or her love of, and affection toward, the recipient spouse upon the occasion of the parties' marriage or at some point thereafter. Since a promise to marry does not constitute consideration in money or money's worth, such a transfer is unambiguously a gift.[10] Again, however, the unlimited gift tax marital deduction of Code Sec. 2523(a) would shield such a transfer from the federal gift tax if the recipient spouse were a citizen of the United States.

In the case of the transfer of property by an individual to his or her nonresident alien spouse (in the case of the federal income tax), or noncitizen spouse (in the case of the federal gift tax), however, potentially serious tax consequences may result. In the event of a transfer of property by an individual to his or her nonresident alien spouse, any property transferred in exchange for the waiver of support rights will cause the recognition of gain to the extent that the value of the property transferred in exchange for the waiver of support rights exceeds the transferring spouse's basis in such property.[11] Under the rule set forth by the U.S. Supreme Court in *T.C. Davis*,[12] the recipient spouse will be deemed to have provided consideration for the transfer in money or money's worth in the form of a relinquished claim to support in an amount equal to the value of the property received. Notably, the release of marital rights other than the right to receive support from one's spouse does not provide consideration in money or money's worth.[13]

To the extent that no consideration in money or money's worth is furnished in exchange for the waiver of marital rights, as would be the case in connection with a transfer of property in exchange for the love and affection of the recipient spouse, or where the recipient spouse's waiver is of marital rights other than support rights, no income tax consequences arise, but the transfer would be a taxable gift that would not enjoy the protection from the federal gift tax afforded by the

unlimited gift tax marital deduction of Code Sec. 2523(a); instead Code Sec. 2523(i) provides for an increased annual exclusion for gifts of present interests to a noncitizen spouse which, for calendar year 2002, is $110,000 *per annum*, and which is indexed to increase with inflation.[14]

A practical solution to the tax problems inherent in an individual transferring property to (or in trust for the benefit of) his or her nonresident alien or noncitizen spouse is to effect such a transfer through an irrevocable "grantor" trust, the transfers to which would be deemed to be "incomplete" gifts by the transferor spouse through the inclusion in the trust agreement of a retained limited power of appointment. In order to provide the recipient spouse with a level of comfort that the transferor spouse's limited power of appointment cannot, as a practical matter, be exercised to appoint the property from the trust to someone other than the recipient spouse in the event of marital discord, the transferor spouse's limited power of appointment might be made exercisable only in conjunction with the consent of a nonadverse party designated by the recipient spouse at the time the trust agreement is entered into (*i.e.,* a friend or relative of the recipient spouse).

Drafting for an Incomplete Gift

According to the Treasury Regulations, a gift is incomplete "… if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard."[15] As a consequence, the transferor spouse can transfer property to a trust for the exclusive benefit of his or her noncitizen spouse and, by retaining a limited[16] power of appointment, avoid the imposition of the gift tax since the gift will thus be rendered "incomplete."[17] That such a structure effectively avoids the imposition of the gift tax should not even raise any public policy concerns relating to the integrity of the U.S. tax base. This is because property that is the subject of an incomplete gift will necessarily remain subject to taxation by the United States when an estate tax is ultimately levied upon the estate of the transferor spouse (unless, of course, additional planning is undertaken to negate, minimize or defer the estate tax; or, if the ostensible "repeal" of the estate tax is at some point made permanent).[18] Alternatively, if the transferor spouse relinquishes or terminates his or her retained limited power of appointment at some point during his or her lifetime, the transferor spouse will be deemed to have completed the gift and the federal gift tax will then apply.[19]

Since the trust agreement under discussion would, of necessity, have a retained limited power of appointment in the transferor spouse, the trust would automatically be deemed a grantor trust under Code Sec. 674(a).

Of course, while the simple expedient of retaining a limited power of appointment in the transferor spouse negates any gift tax consequences, it will at the same time almost certainly be at odds with the recipient spouse's requirement that the transfer provide some certainty as to his or her continued entitlement to use, and otherwise benefit from, the transferred property. Unfortunately, to be effective from a federal gift tax perspective, the transferor spouse's limited power of appointment cannot be made exercisable solely in favor of the recipient spouse. This is because a gift will not be considered incomplete if the transferor spouse has only reserved the power to change the manner or time of enjoyment of the property that is the subject to the gift.[20] It is, therefore, significant that the Treasury Regulations provide that "[a] donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom."[21] By reason of that Treasury Regulation, a third party without a substantial adverse interest in the disposition of the transferred property or the income therefrom, who is designated (or at the very least approved of) by the recipient spouse, can be interposed between the transferor spouse and his or her unrestricted exercise of the retained limited power of appointment.

An "adverse interest" has been defined as a legal or equitable interest in property that would be adversely affected by an exercise of the power of appointment.[22] The recipient spouse, or any individual having a remainder interest in the trust, would certainly be deemed to have an "adverse interest" for this purpose. By contrast, a trustee, as

such, is not a person having an adverse interest in the disposition of the trust property or its income.[23] A trustee (who is not also a beneficiary of the trust) is generally not considered as having an adverse interest in the trust property because he or she does not have a sufficient economic interest in the trust.[24]

In order to ensure that the transferor spouse's gift to the trust is deemed "incomplete," while at the same time ensuring that the recipient spouse has a close approximation of the privileges, immunities and protections that would have been afforded had an outright transfer of the property to the recipient spouse been feasible, the trust agreement might provide that the transferor spouse must obtain the consent of the trustee, or some other nonadverse party, in connection with an exercise of the transferor spouse's retained limited power of appointment. To the extent that the nonadverse party is "hand picked" by the recipient spouse from a pool of friends and family, the recipient spouse would likely be unconcerned with the practical ability of the transferor spouse to subsequently exercise his or her retained limited power of appointment in a manner detrimental to the recipient spouse's interests.

Finally, and although it seems unlikely, where the transferor spouse's retained limited power of appointment is exercisable only with the consent of a third party actually designated by the recipient spouse, there may exist a possibility that the IRS will deem such person to be the recipient spouse's agent or alter ego. Since the recipient spouse is clearly a person "… having a substantial adverse interest in the disposition of the transferred property or the income therefrom …", the transferor spouse's retained limited power of appointment might thus be deemed ineffective to render the gift "incomplete." Although the author has uncovered no authority that would support the IRS were it to take this position, conservative counsel might propose that a friend, rather than a relative, of the recipient spouse be appointed as the nonadverse party without whose consent the transferor spouse cannot exercise his or her retained limited power of appointment. If a relative is, nevertheless, appointed to such position, care must be taken to ensure that such person not have even a contingent remainder interest in the trust. If such person does have a contingent remainder interest in the trust, the IRS might find such interest to be "substantial" under the extremely subjective standards of the Treasury Regulations, and thereby deem the retained limited power of appointment as ineffective to render the gift incomplete. If, however, the recipient spouse were comfortable with such appointment, his or her attorney, accountant or other professional advisor might optimally be appointed as an appropriate "nonadverse" party in order to minimize the risk of a challenge from the IRS on this point. In this regard, the grantor trust rules have a concept similar to that of the federal gift tax regulations regarding the effect of certain retained powers that are exercisable only with the consent of a "nonadverse" party; in that context, at least, the possibility that the trust's remainder beneficiary may in the future employ the independent trustee, if the trust has sufficient assets, does not give the trustee a beneficial interest in the trust that would make the trustee an adverse party *vis á vis* the grantor.[25]

Drafting for a Grantor Trust

Code Secs. 671 through 679 define those circumstances under which a trust will be deemed to be a "grantor trust" and, as a consequence, the grantor will be treated as the owner of the trust for income tax purposes. Specifically, Code Sec. 671 provides that

> [W]here it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual …

Since the trust agreement under discussion would, of necessity, have a retained limited power of appointment in the transferor spouse, the trust would automatically be deemed a grantor trust under Code Sec. 674(a). That section provides that "[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."[26] For this purpose, the term "adverse party" is defined as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power that he possesses respecting the trust …"[27] and a "nonadverse party" is defined

as "… any person who is not an adverse party."[28]

Although it seems as though one might comfortably rely upon Code Sec. 674(a) to cause the trust under discussion to be a grantor trust, it is worth mentioning, at least, that Code Sec. 677(a) provides a natural redundancy to the grantor trust issue for the trust under discussion. That latter section provides that "[t]he grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be … distributed to the … grantor's spouse … [or] held or accumulated for future distribution to the grantor or the grantor's spouse …"[29] If desired, further assurances of grantor trust status can be included in the trust agreement without adversely affecting any other aspect of the trust, although it should not be necessary to do so.[30]

As a "grantor trust," no income tax consequences will attend the transfer of property from the transferor spouse to the trust. Therefore, notwithstanding the fact that the recipient spouse might be releasing support rights in exchange for the transfer of appreciated property by the transferor spouse, or that the recipient spouse might be providing to the transferor spouse some other consideration in money or money's worth, the transferor spouse will not be deemed to recognize gain on the transfer.

Incidental Benefits

The use of a trust in lieu of an outright transfer of property has the potential to provide additional significant nontax benefits to both the transferor spouse and the recipient spouse. In the first instance, since the transfer of property has, through the use of a trust of the type described in this article, been made nontaxable, the transferor spouse's transfer of property need no longer be implicitly or explicitly tax-affected (*i.e.*, the transferor spouse can transfer more property to the recipient spouse in light of the fact that there is no tax cost attendant to such transfer). Although the transferor spouse remains "out of pocket" as to the whole amount, the transferor spouse still has at least some level of access to the transferred property since it resides in a trust for the benefit of the recipient spouse and the parties are, presumably, happily married at the time in question. Therefore, the transferor spouse might still have some level of access to the property through the recipient spouse. Obviously, in the case of a taxable transfer, a smaller amount would likely be transferred to the recipient spouse and neither spouse would have any access to the additional value used to pay the taxes attendant to such transfer.

Equally, if not more, significant is the potential creditor protection that a transfer in trust affords the parties. By reason of their "deep pockets," wealthy individuals might be considered to be at substantially greater risk of creditor threat than poorer individuals. Since spendthrift protections are afforded to properly drafted trusts in each of the 50 states, as well as in many other jurisdictions throughout the common law world, a simple mechanism for asset protection is the use of a trust in lieu of an outright gift. This, of course, protects the recipient spouse from the consequences that might arise should he or she come under creditor attack at some point in the future. In addition, in those instances where the transferor spouse would otherwise merely contract with the recipient spouse to transfer property to the recipient spouse at some future time, the use of a trust also protects against the possibility that the transferor spouse might him- or herself come under creditor attack or become insolvent.

Finally, a trust provides certain instances of flexibility that an outright transfer of property would not. For example, the fact that the trust at issue would be a grantor trust broadens the class of property that the transferor spouse might consider transferring since the transferor spouse would be able to retain the beneficial tax attributes of the transferred property. As an example, the transfer of a principal residence into such a trust would not have the effect of extinguishing the transferor spouse's ability to deduct mortgage interest or real estate taxes, or to exclude some portion or all of the proceeds of sale. With a grantor trust, the transferor spouse would also be able to transfer a business interest in a corporation or limited liability company that

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has elected to be taxed as an S corporation without concern for the fact that the recipient spouse might be a nonresident alien and consequently disallowed as an owner of the S corporation.[31]

Conclusion

Where an individual finds it necessary or desirable to transfer substantial property to his or her spouse, the natural tendency is probably to effect an outright transfer. At a minimum, the beauty of the simplicity of an outright transfer of property might recommend it. Other benefits, which might be thought to outweigh the benefit of the simplicity of an outright transfer, however, could possibly tilt the scales in favor of a transfer in trust. Absent other considerations (such as a nonresident alien or noncitizen spouse), knowledgeable and experienced advisors might reasonably differ in providing their clients with a recommendation as to the structure of the transaction. When, however, the issue of the federal income tax is introduced into the equation (as is necessarily the case where the recipient spouse is a nonresident alien), or the issue of the federal gift tax is introduced into the equation (as is necessarily the case where the recipient spouse is not a citizen of the United States), most, if not all, advisors would likely agree that a structure that avoids taxation must be found. The alternative, of course, is to advise the transferor spouse that he or she must, in effect, gross up his or her intended transfer in order to account for the tax that will be assessed upon the transfer. The trust structure described here should have the desired effect of avoiding the imposition of any current tax, while at the same time, satisfying the recipient spouse with a transaction that provides the recipient spouse with a close approximation of the privileges, immunities and protections that would have been afforded to the recipient spouse had an outright transfer of such property been feasible.

ENDNOTES

1 All references to the Code, and to section references thereunder, are to the United States Internal Revenue Code of 1986, as amended.

2 "No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse …" Code Sec. 1041(a)(1).

3 "Where a donor transfers during the calendar year by gift an interest in property to a donee who at the time of the gift is the donor's spouse, there shall be allowed as a deduction in computing taxable gifts for the calendar year an amount with respect to such interest equal to its value." Code Sec. 2523(a).

4 While the Internal Revenue Code also generally protects testamentary inter-spousal transfers from the federal estate tax, a discussion of the federal estate tax in the context of inter-spousal transfers is, for the most part, beyond the scope of this article. *See, however,* Code Sec. 2056, which generally provides for an unlimited estate tax marital deduction.

5 *See* Code Sec. 1041(d) ("Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien").

6 *See* Code Sec. 2523(i)(1) ("If the spouse of the donor is not a citizen of the United States—no deduction shall be allowed under this section …").

7 *See, e.g.,* Code Sec. 877(a) (providing that a tax-motivated expatriate will be subject to taxation by the United States for a period of 10 years following his or her expatriation from the United States).

8 Since the client's motivation in effecting the proposed transfer of property to his or her nonresident alien or noncitizen spouse is, in most cases, not to avoid U.S. taxation, a solution that leaves the property potentially subject to future taxation by the United States would not militate against implementing the structure described in this article.

9 Transfer tax deferral through an actual statutory qualified domestic trust is available only for *testamentary* transfers. *See* Code Sec. 2056A.

10 Reg. §25.2512-8 ("A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift …").

11 Loss, however, will be disallowed under Code Sec. 267(a) if the transferor spouse's basis exceeds the transferred property's fair market value since the transferor spouse and the recipient spouse are members of the same family under Code Sec. 267(c)(4).

12 *T.C. Davis,* SCt, 62-2 USTC ¶9509, 370 US 65, 82 SCt 1190.

13 *See W.H. Wemyss,* SCt, 45-1 USTC ¶10,179, 324 US 303, 65 SCt 652; *C.E. Merrill v. Fahs,* SCt, 45-1 USTC ¶10,180, 324 US 308, 65 SCt 655; *B.B. Bristol,* CA-1, 41-2 USTC ¶10,070, 121 F2d 129; *See also* Reg. §25.2512-8. The policy basis for this distinction between a waiver of support rights and a waiver of other marital rights has been expressed by the IRS, as follows:

"Generally, a husband has a duty to support his wife during their joint lives or until she remarries. The satisfaction of this legal obligation does not have the effect of diminishing the husband's estate any more than the satisfaction of any other legal obligation. A transfer to a wife in settlement of inheritance rights is, on the other hand, a present transfer of what would otherwise be a major portion of the husband's estate on death. Section 25.2512-8 of the regulations specifically states that the release of dower or curtesy or a statutory substitute for dower or curtesy (inheritance rights) is not a consideration in money or money's worth that would prevent taxation of the transfer. The regulations make no reference to support rights. Consequently, since support rights are distinguishable from inheritance rights, a surrender of support rights is not a surrender of "other marital rights," as that phrase is used in the regulations. A release of support rights by a wife constitutes a consideration in money or money's worth." Rev. Rul. 68-379, 1968-2 CB 414.

14 "If the spouse of the donor is not a citizen of the United States—(2) section 2503(b) shall be applied with respect to gifts which are made by the donor to such spouse and with respect to which a deduction would be allowable under this section but for paragraph (1) by substituting "$100,000" for "$10,000" …" Code Sec. 2523(i)(3).

15 Reg. §25.2511-2(c). It should be noted that is not necessary for the donor to have the power to actually name himself or herself as a beneficiary in order for the gift to be incomplete.

16 Although a retained general power of appointment would garner the same tax result, nontax considerations would, in most cases, recommend against using a retained general power of appointment. A discussion of those considerations, however, is beyond the scope of this article.

ENDNOTES

[17] As an aside, if a donor contends that the donor's retained power over gifted property renders the gift incomplete and hence, not subject to gift tax as of the calendar year of the initial transfer, the transaction should be disclosed in the return for the calendar year of the initial transfer and evidence showing all relevant facts, including a copy of the trust agreement, are to be submitted with the gift tax return. Reg. §25.6019-3(a).

[18] Various methods can be used to negate, minimize or defer the estate tax on property placed in the type of trust discussed in this article. As an example, "qualified domestic trust" provisions under Code Sec. 2056A can be integrated into the trust in order to defer until the earlier of (1) the death of the recipient spouse, or (2) the distribution of property to the recipient spouse, any estate tax which would otherwise be imposed upon the death of the transferor spouse. Alternatively, the recipient spouse might subsequently become a citizen of the United States, at which point the trustee can be required (or at least be given the discretion) to distribute the property out of trust to the recipient spouse. In the meanwhile, the trust can be drafted to take advantage of the enhanced annual exclusion applicable to transfers to a noncitizen spouse by requiring the transfer of $110,000 *per annum* out of the trust to the recipient spouse.

[19] *See* Reg. §25.2511-2(f).

[20] Reg. §25.2511-2(d). As an aside, such an overly restricted limited power of appointment would also be insufficient to make the trust a grantor trust under Code Sec. 674(a). *See* Code Sec. 675(b)(5), (6).

[21] Reg. §25.2511-2(e).

[22] *See, e.g., O.H. Prouty*, CA-1, 40-2 USTC ¶9734, 115 F2d 331, 335; Rev. Rul. 58-395, 1958-2 CB 398.

[23] Reg. §25.2511-2(e).

[24] *See, e.g., M.H. Latta*, CA-3, 54-1 USTC ¶10,940, 212 F2d 164; *J.M Towle Est.*, 54 TC 368, Dec. 29,982 (1970).

[25] *See* LTR 8938063 (June 29, 1989) (independent trustee had no legally enforceable right to employment that would create a beneficial interest); *F.G. Paxton*, CA-9, 75-2 USTC ¶9607, 520 F2d 923, *cert. denied*, SCt, 423 US 1016, 96 SCt 450 (1975).

[26] Code Sec. 674(a). Note, however, that if Code Sec. 674(a) is to be relied upon to make the trust a grantor trust, the transferor spouse's limited power of appointment must be an *inter vivos* power since Code Sec. 674(b)(3) excepts from the application of Code Sec. 674(a) powers, which are exercisable only by last will and testament (unless the income of the trust is to be accumulated for such disposition, or may be so accumulated in the discretion of the grantor or a nonadverse party, or both without the approval or consent of any adverse party).

[27] Code Sec. 672(a).

[28] Code Sec. 672(b).

[29] Code Sec. 677(a)(1), (2).

[30] *See, e.g.*, Code Sec. 673(a), which provides that "[t]he grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value at such inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion."

[31] *See* Code Sec. 1361(b)(1)(C).