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Introduction

The marital deduction is one of the most commonly used estate planning tools. In the estate tax context, the marital deduction is, in most instances, relatively straightforward: it permits an estate to deduct the full value of property that is transferred from the decedent to his or her surviving spouse. One situation in which the marital deduction is not so simple, however, is where the surviving spouse is not a U.S. citizen.

Based on the dubious proposition that a non-citizen spouse of a U.S. citizen would likely return to the country of his or her origin after the citizen spouse's death, Congress, in 1988, enacted modifications to the marital deduction rules designed to ensure that property passing tax free to a non-citizen spouse would be subjected to U.S. transfer tax at some future time, rather than escaping such taxation if removed from the U.S. by the departing non-citizen spouse.[1] Under these modifications, specific rules would have to be followed in order for a transfer to a non-citizen spouse to even qualify for the marital deduction in the first estate, including that the property must pass in a Qualified Domestic Trust ("QDOT") for the benefit of the surviving spouse. Then, if the property so qualified, the first spouse's estate would only be entitled to deduct the value of the QDOT property until the surviving spouse later dies (or sooner in certain instances), at which time *both* estates would be taxed on the property, although the surviving spouse's estate would be entitled to a credit for taxes paid by the first spouse's estate.

As enacted, this disparate treatment of married couples depending on their citizenship has led to a significant problem where the surviving

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[1] *See* Technical & Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988); H.R. Rep. No. 100-795, pt. 2, at 592 (1988) ("Property passing to an alien surviving spouse is less likely to be includible in the spouse's estate, since to avoid taxation on the worldwide estate, the spouse need only give up U.S. residence.").

non-citizen spouse makes charitable dispositions in his or her Will. A reduction of the credit to which the surviving spouse's estate is entitled in such cases results in the double taxation of at least a portion of the QDOT property, thereby undermining the essential purpose of the marital deduction — one-time taxation of marital property — and, at the same time, decreasing the size of the surviving spouse's charitable bequest if the taxes are payable from the charitable portion of the estate. The reason for this is simple. While Congress enacted an entirely new provision for the creation and taxation of QDOTs (section 2056A), it tried to shoe horn the QDOT credit into a pre-existing provision (section 2013) that governs the credit available for property previously taxed in another estate (hereinafter sometimes referred to as the "PTP credit"). And while Congress and the Treasury Department made certain modifications to section 2013 and the Regulations to accommodate QDOTs, they failed to eliminate one element of the section 2013 Regulation that leads to the problem: the charitable deduction adjustment.

The charitable deduction adjustment is a mechanism in Regulation section 20.2013-3 that reduces the credit an estate may take for taxes paid on property previously transferred to its decedent if a portion of the estate is passing to charity. The logic is that some of the property received from the first estate passes to charity from the second estate, and, therefore, will generate a charitable deduction for the second estate that allows it to pass tax free to the charity, obviating the need for a PTP credit with respect to that portion of the property. Unfortunately, this logic is flawed in the QDOT situation, because the property in the QDOT passes to the remainder beneficiaries of the QDOT and not to the beneficiaries of the surviving spouse's estate. The credit is reduced even though no portion of the QDOT property will pass to charitable beneficiaries from the surviving spouse's estate. With respect to QDOTs, therefore, the application of the adjustment wholly undermines the basic principles of the marital and charitable deductions.

Nevertheless, the I.R.S. continues to require the charitable deduction adjustment. Indeed, in a recent matter involving this author, the I.R.S. reduced the credit available to the estate of a non-citizen U.S. resident decedent who had been the beneficiary of a QDOT established by her late husband because her Will bequeathed a portion of her residuary estate to charity. Despite this author's written protests that the charitable deduction adjustment should not be applied, an I.R.S. regional office, allegedly confirmed by the national office, refused to change its position.[2] Because the I.R.S. continues to enforce this provi-

[2] Although the I.R.S. refused to change its position with respect to the application of the charitable deduction adjustment, it did provide the estate with other concessions and, as a result, the Federal tax audit is now closed.

sion notwithstanding the fact that it is contrary to the principles underlying the marital and charitable deductions, the Regulations must be amended to eliminate the application of the charitable deduction adjustment to property passing in a QDOT.[3]

I. The Marital Deduction

In 1948 Congress passed the first provisions for a marital deduction for estate taxes.[4] An essential purpose of the marital deduction was to "codify the long-standing notion that marital property belongs to the unitary estate of both spouses," by taxing a husband and wife as one economic unit for estate tax purposes.[5] To achieve this, Congress and the Treasury Department created a statutory and regulatory scheme that proscribed the taxation of interspousal transfers of assets upon the death of one spouse, so as to eliminate the "double taxation" that would otherwise result if such property was also taxed on the death of the other spouse.[6]

As first constituted, the marital deduction allowed an individual to pass fifty percent of his or her assets to his or her surviving spouse without subjecting the property to the estate tax.[7] The 1948 Act also set forth specific requirements for how the property must pass if it were to qualify for this deduction. Most notably, it disqualified terminable interests — i.e., an interest that will terminate upon the lapse of time, or the occurrence (or failure of occurrence) of an event or contingency — save a few exceptions. All of these exceptions required the surviving spouse to have control over the ultimate disposition of the property

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3 Since the passage of the Technical & Miscellaneous Revenue Act of 1988, ACTEC has published several articles that discuss and analyze the QDOT. *See, e.g.*, Samuel A. Donaldson, *A Hitchhiker's Guite* [sic] *to International Estate Planning: Estate Planning for United States Citizens with Assets Abroad and for Nonresidents with United States Assets*, 33 ACTEC J. 228 (2008); Dennis I. Belcher, *Transfer Tax Planning for Noncitizen Spouses*, 16 ACTEC Notes 102 (1990); Jerry J. McCoy, *Estate Tax Treatment of Noncitizens and Noncitizen Spouses*, 14 ACPC Prob. Notes 323 (1989). However, none of these addresses the charitable deduction adjustment anomaly that is the subject of this article.

4 *See* Schroeder v. United States, 924 F.2d 1547, 1551 (10th Cir. 1991). The focus of this article will be the estate tax marital deduction, although most of these provisions have corresponding provisions in the gift tax area.

5 Estate of Shelfer v. Comm'r, 86 F.3d 1045, 1048 (11th Cir. 1996) (quoting Shelfer v. Comm'r, 103 T.C. 10, 25 (1994) (Beghe, J., dissenting)).

6 *See id.* at 1048-50; *Schroeder*, 924 F.2d at 1555.

7 *See* Staff of Joint Comm. on Tax'n, 94th Cong., General Explanation of the Tax Reform Act of 1976, 532 (Comm. Print 1976) [hereinafter Gen. Exp. of the Tax Reform Act of 1976].

(without which the property could escape all taxation and not just double taxation).[8]

Over time, the scope of the marital deduction was expanded. In 1976, Congress increased the maximum allowable marital deduction to an amount equal to the greater of $250,000 or fifty percent of the decedent's adjusted gross estate.[9] Five years later, Congress enacted the unlimited marital deduction, which allowed an individual's estate to deduct all assets passing in qualifying transfers to a surviving spouse.[10] At the same time, Congress expanded the categories of terminable interests that could qualify for the marital deduction by allowing a marital deduction for property passing to a "qualified" terminable interest property trust ("QTIP Trust"), upon the making of an election by the executor of the first spouse's estate. Unlike the previously allowed exceptions, a QTIP Trust allowed the first spouse to control the disposition of the trust assets upon the surviving spouse's death.[11] This was more consistent with the average testator's willingness to provide for a surviving spouse during his or her lifetime, but without relinquishing the power to determine how the property will ultimately be distributed.[12] At the same time, it preserved the government's right to receive a tax on the property on the death of the second spouse.[13]

But in 1988 Congress took a step back. It inserted a provision in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") that limited the marital deduction's availability to certain couples. Due to concerns that non-citizens would return to their countries of origin after the death of their citizen spouses, taking with them the property inherited tax free from their spouses, and thus avoiding the taxation of that

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[8] *See Shelfer*, 86 F.3d at 1049. Two of the exceptions were (1) when a surviving spouse was given a life estate in the passed property with a general power of appointment, and (2) when the surviving spouse received the entire interest in the property in trust, with the remainder passing to the surviving spouse's estate upon his or her death. *See infra* note 18 and accompanying text.

[9] *See* GEN. EXP. OF THE TAX REFORM ACT OF 1976, at 532-33. The "adjusted gross estate" equals the gross estate reduced by the sum of deductions allowable under sections 2053 and 2054. I.R.C. § 6166(b)(6).

[10] *See* STAFF OF JOINT COMM. ON TAX'N, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 231, 234-35 (Comm. Print 1981).

[11] *See id.* at 235; *see also* Shelfer v. Comm'r, 86 F.3d 1045, 1049 (11th Cir. 1996).

[12] *See Shelfer*, 86 F.3d at 1049 ("[T]he purpose of the QTIP trust provisions was to liberalize the marital deduction to cover [the] trust instruments that provide ongoing income support for the surviving spouse while retaining the corpus for the children or other beneficiaries."). Since the enactment of the Economic Recovery Tax Act of 1981, virtually all marital deduction trusts have been structured as QTIP Trusts.

[13] *See* I.R.C. § 2044.

property on either death,[14] TAMRA amended the then-existing law, which provided for a marital deduction regardless of the surviving spouse's citizenship. TAMRA prohibited an estate from taking a marital deduction for property passing to a non-citizen spouse, unless the property passed in a QDOT.[15] Whether there was any significant statistical data to support these concerns is questionable. Nevertheless, since 1988, the QDOT has remained the only means by which an estate of a U.S. citizen can take a marital deduction for property passing to a surviving non-citizen spouse.

II. The Qualified Domestic Trust

A QDOT is a trust that meets the following four conditions, which are set forth in section 2056A(a): (1) the trust instrument requires that at least one trustee of the trust be a U.S. citizen or a domestic corporation; (2) the trust instrument provides that no distribution of principal be made from the trust unless a U.S. citizen or domestic corporation trustee has a right to withhold from the distribution the tax imposed on it under section 2056A; (3) the trust meets the requirements of all applicable regulations; and (4) the executor of the decedent's estate makes the QDOT election on the decedent's estate tax return.[16]

Even if a trust qualifies as a QDOT, it must still meet the requirements of section 2056 in order to be entitled to a marital deduction. As discussed above, because a QDOT gives the surviving spouse a terminable interest in the passed property, it does not qualify for the marital deduction in the first estate unless an exception to the terminable interest rule applies.[17] The two exceptions generally applicable are (1) the surviving spouse receives a life estate in the passed property with a general power of appointment (section 2056(b)(5)); or (2) the property passes in a QTIP Trust (section 2056(b)(7)).[18]

Once the QDOT qualifies for the marital deduction, however, it will not be the typical marital deduction situation, in which only the sur-

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[14] *See* I.R.C. § 2103 ("[T]he value of the gross estate of every decedent nonresident not a citizen of the United States shall be that part of his gross estate (determined as provided in Section 2031) which at the time of his death is situated in the United States."); *see also* H.R. Rep. No. 100-795, pt. 2, at 592 (1988).

[15] *See* Technical & Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5033, 102 Stat. 3342, 3670 (1988).

[16] I.R.C. § 2056A(a).

[17] *Id.* § 2056(b).

[18] A third, less common, exception is known as an "estate trust," in which the surviving spouse receives the entire interest in the property in trust, and the remainder passes to the surviving spouse's estate upon his or her death. *See id.* § 2056(b)(1); Treas. Reg. § 20.2056(c)-2(b)(1). This is generally utilized in a situation where the mandatory payment of current income to the surviving spouse is not feasible.

viving spouse's estate pays taxes on the passed property. Rather, for QDOTs, the *first spouse's* estate is required to pay estate tax on the QDOT property, upon the occurrence of one of following events: (1) a non-exempt distribution of trust principal prior to the death of the surviving spouse; (2) the trust ceasing to qualify as a QDOT; or (3) the death of the surviving spouse.[19] Upon the happening of one of these "taxable events," an estate tax is imposed on the value of the QDOT property that was distributed, or which otherwise becomes subject to the tax.[20]

With respect to the last taxable event (the death of the surviving spouse), the amount of the estate tax equals the tax that would have been imposed on the QDOT property, valued as of the date of the *surviving spouse's* death, if it had been included in the *first spouse's* estate.[21] At the same time, however, the property passing in a QDOT is *also* included in the gross estate of the surviving spouse.[22] To avoid the double taxation that would otherwise result in taxing the QDOT property in both spouses' estates, the Code permits the estate of the surviving spouse to take a credit for the taxes paid by the first spouse's estate (the "QDOT credit").[23] The credit is codified in section 2056(d)(3) as follows:

> If -
>
> (A) property passes to the surviving spouse of the decedent (hereinafter in this paragraph referred to as the 'first decedent'),

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19 I.R.C. § 2056A(b)(1), (4). Neither distributions of income nor distributions of principal that are made on account of hardship are subject to estate tax. *Id.* § 2056A(b)(3).

20 *Id.* § 2056A(b)(1), (4).

21 *Id.* § 2056A(b)(2).

22 *See id.* § 2041 (including in gross estate value of property over which decedent had a general power of appointment); *id.* § 2044 (including in gross estate value of any property in which decedent had a qualifying income interest for life, including any property for which a marital deduction was allowed by reason of section 2056(b)(7)). Section 2044 includes not only property passing in a QTIP Trust (for which a QTIP election was made by the executor), but also property passing in a QDOT that provides the surviving spouse with a qualifying income interest for life. *See* H.R. Rep. No. 100-795, pt. 2, at 593 (1988); I.R.C. §§ 2056(d)(2), 2056A.

23 *See* T.D. 8612, 1995-38 I.R.B. 7. The QDOT credit is a creature of federal estate tax law and not necessarily applicable to state estate tax law. For example, in New York, the QDOT credit is unnecessary since the first spouse's estate is never taxed on the QDOT property; the QDOT is treated as a QTIP Trust for all purposes, and, as a result, is taxed only in the surviving spouse's estate.

(B) without regard to this [subsection (d)],[24] a [marital] deduction would be allowable under subsection (a) with respect to such property, and

(C) such surviving spouse dies and the estate of such surviving spouse is subject to the tax imposed by this chapter,

the Federal estate tax paid (or treated as paid under Section 2056A(b)(7)) by the first decedent with respect to such property shall be allowed as a credit under Section 2013 to the estate of such surviving spouse and the amount of such credit shall be determined under such section without regard to when the first decedent died and without regard to subsection (d)(3) of such section.[25]

In other words, when a QDOT meets each of the three requirements of section 2056(d)(3), the estate of the surviving spouse is entitled to a credit against its estate tax liability for the tax paid by the first decedent, in an amount determined under section 2013, as modified by the flush language quoted above.[26]

III. Section 2013: Credit For Tax On Prior Transfers

Section 2013 permits the estate of a decedent (the transferee) to receive a credit for property of the estate that was received from another person (the transferor), and that was subject to the Federal estate tax, within ten years prior to the transferee's death or two years thereafter.[27] The purpose of the credit is to ameliorate, at least in part, the double taxation that results from the same property being taxed in two separate estates within a short period of time.[28]

Because the perception, if not the fact, of double taxation diminishes as the period of time between the death of the transferee and the death of the transferor increases, the availability and size of the PTP credit depends on the interval of time between the two deaths. The PTP credit is only available if the transferee dies within 2 years before or 10 years after the transferor's death, and the size of the credit gradually

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[24] Subsection (d) of section 2056 provides that a marital deduction shall not be allowed if the surviving spouse of the decedent is not a U.S. citizen, unless the property passes to the surviving spouse in a QDOT. I.R.C. § 2056(d)(1)-(2).

[25] *Id.* § 2056(d)(3).

[26] *Id.* This tax is, of course, usually paid by the QDOT itself.

[27] *Id.* § 2013(a).

[28] *See* Estate of Harrison v. Comm'r, 115 T.C. 161, 164 (2000) (finding that purpose of credit is "to prevent the diminution of an estate by the imposition of successive taxes on the same property within a brief period") (quoting S. Rep. No. 83-1622, at 122 (1954)); Estate of Sparling v. Comm'r, 552 F.2d 1340, 1346 (9th Cir. 1977) (finding that purpose of Section 2013 is to "avoid successive oppressive taxation of the same property").

decreases (by 20% for every two years) as the time period between the two deaths increases.[29] For example, if the transferee dies within 2 years of the transferor, the credit is 100% of the amount calculated under section 2013; but, if the transferee dies within the ninth or tenth year after the transferor's death, the credit is only 20% of such amount.[30]

The PTP credit was also designed to prevent the transferee's estate from receiving a windfall — for example, in the case of a lower tax rate at the time of the transferee's death. Thus, the credit equals either the Federal estate tax paid by the transferor's estate on the property or the Federal estate tax owed by the transferee's estate on the property, whichever is less.[31] These are known as the First and Second Limitations, respectively, and are calculated using formulas set forth in the Regulations under section 2013.[32]

The First Limitation equals the amount of Federal estate tax attributable to the previously transferred property when it was included in the *transferor's estate*.[33] It is calculated by using the following equation:

$A = B \times C/D$, where
A = the amount of the credit
B = the transferor's adjusted Federal estate tax
C = the value of the property transferred
D = the transferor's adjusted taxable estate[34]

The Second Limitation equals the amount of Federal estate tax that would have to be paid on the previously transferred property if it were included in the *transferee's estate*.[35] It is calculated by taking the difference between (1) the estate tax that would be imposed on the trans-

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29 I.R.C. § 2013(a).

30 *Id.*

31 The PTP credit is only for federal estate taxes paid; it does not provide a credit for any state death or estate taxes paid.

32 *See* Treas. Reg. § 20.2013-2 ("First Limitation"); *id.* § 20.2013-3 ("Second Limitation").

33 *See id.* § 20.2013-2.

34 *Id.* The transferor's adjusted Federal estate tax equals the amount of Federal estate tax paid by the transferor's estate plus any section 2012 gift tax credit and any section 2013 PTP credit allowed to the transferor's estate. *See id.* § 20.2013-2(b)(1)(2). The transferor's adjusted taxable estate equals the amount of the transferor's taxable estate decreased by the amount of any "death taxes" paid with respect to transferor's gross estate (i.e., Federal estate tax plus any state or foreign death taxes), and increased by the amount of the exemption allowed under either section 2052 or section 2106(a)(3) of the Code in computing the transferor's taxable estate. *See id.* § 20.2013-2(c). Notably, since the last amendment to Regulation section 20.2013-2(c), the exemptions allowed under sections 2052 and 2106(a)(3) of the Code have been repealed. Thus, this article assumes that the transferor's adjusted taxable estate should not be increased by the exemptions previously allowed under those sections.

35 *See id.* § 20.2013-3(a).

feree's estate if the estate included the value of the previously transferred property but did not have the benefit of the PTP credit[36] and (2) the estate tax that would be imposed on the transferee's estate if the estate did not include the value of the previously transferred property.[37] In other words, it is equal to the additional tax generated by the inclusion of the transferred property in the second estate.

In calculating the subtrahend in the Second Limitation equation,[38] the Regulations require that any charitable deduction allowable to the transferee's estate be reduced by an amount that is calculated using the following equation:

E = F x G/H, where
E = the amount the charitable deduction must be reduced
F = the charitable deduction otherwise allowable
G = the value of the transferred property
H = the value of the transferee's gross estate reduced by the amount of deductions for expenses, indebtedness, taxes, losses, etc. allowed under sections 2053 and 2054 or section 2106(a)(1) — i.e., the transferee's adjusted gross estate.[39]

By reducing the charitable deduction otherwise allowable to the transferee's estate, the "charitable deduction adjustment" causes an increase in the hypothetical net estate tax imposed on the transferee's estate under part 2 of the Second Limitation equation, thus reducing the Second Limitation by shrinking the difference between (1) and (2) above, and accordingly reducing the potential PTP credit available to the transferee's estate. This adjustment is designed to prevent a tax windfall to the transferee's estate, because it can be presumed that part of the previously taxed property is being used to make the charitable bequest and is thus not generating estate tax in the second estate.[40]

In the typical previously taxed property situation (i.e., where property passes outright to a non-spouse, and the transferee has total control over the disposition of the property), the charitable deduction adjustment seems appropriate, as demonstrated by the following example:

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36 Also not included in the calculation is any credit for foreign death taxes paid. *See id.*

37 *See id.*

38 *See id.* § 20.2013-3(a)(2).

39 *See id.* § 20.2013-3(b). It is unclear whether the gross estate used in variable "H" includes the previously transferred property. This article assumes that it does given that such property appears to be included in "H" in the examples set forth in Regulation section 20.2013-6.

40 *See* TAM 8714001 (Oct. 29, 1986) (where a transferee's estate takes a charitable deduction, "the value of all assets in the estate," including previously taxed property, "would be considered as facilitating the charitable deduction.").

> Jack, a U.S. citizen, died in 2011 with a gross estate of \$50,000,000 and a taxable estate of \$30,000,000, for which he owed only Federal estate tax, in the amount of \$8,750,000. Under Jack's Will, he bequeathed \$10,000,000 to his son, Bob. Bob died in 2012. At the time of his death, Bob's gross estate less deductions for expenses, indebtedness, taxes, losses, etc., was also \$50,000,000. In his Will, Bob bequeathed \$40,000,000 to charity and \$10,000,000 to his sister, Ann.

Because Jack died a year before Bob died, Bob's estate is entitled to a credit for taxes paid by Jack's estate on the \$10,000,000 transferred to Bob, in an amount equal to 100% of the lesser of the First and Second Limitations.

First Limitation

The First Limitation equals the amount of estate tax imposed on Jack's estate and is calculated as follows:

$$\text{Jack's estate tax (\$8,750,000)} \times \frac{\text{Value of property transferred (\$10,000,000)}}{\text{Jack's adjusted taxable estate (\$21,250,000)}}$$

Thus, the First Limitation is \$4,117,647.06.

Second Limitation

The Second Limitation is calculated as follows:

Estate tax imposed on Bob's estate, where the estate includes the value of the transferred property and no section 2013 credit:

Gross estate, minus expenses, losses, etc.	\$50,000,000
Less: Charitable Deduction	40,000,000
Taxable Estate	10,000,000
Estate Tax	3,480,800
Less: Unified Credit	1,772,800[41]
Estate tax	\$1,708,000[42]

Estate tax imposed on Bob's estate, where the estate does not include the value of the transferred property, and the charitable deduction is reduced:

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41 The amount represents the unified credit for the 2012 tax year (exempting \$5,120,000 from taxation), which has been adjusted for inflation pursuant to section 2010(c) of the Code. The unified credit for 2011 was \$1,730,800 (exempting \$5,000,000 from taxation). *See* I.R.S., PUBLICATION 950, Oct. 2011, at 2.

42 The estate tax amount is calculated using the federal estate tax rates for the 2012 tax year. The top estate tax rate for 2012 is thirty-five (35%) percent.

Gross estate, minus expenses, losses, etc.	$40,000,000
Less: Adjusted Charitable Deduction	32,000,000[43]
Taxable estate	8,000,000
Estate Tax	2,780,800
Less: Unified Credit	1,772,800
Estate tax	$1,008,000

Thus, the Second Limitation equals $700,000 ($1,708,000 - $1,008,000).

Credit to Bob's Estate

Bob's estate would be entitled to a PTP credit of $700,000, the lesser of the First and Second Limitation amounts. As a result of the credit, Bob would owe $1,008,000 in estate taxes.[44]

In this example, the $700,000 PTP credit accurately reflects the tax impact the $10,000,000 transferred to Bob under Jack's will has on Bob's estate. Because Jack transferred the $10,000,000 outright to Bob, it was effectively commingled with the other property in Bob's estate to give him $50,000,000 of assets to distribute at his death. As a result, each distribution Bob made consisted of, or can be presumed to consist of, a proportionate share of the previously taxed property. Therefore, since he donated 4/5 of his entire estate to charity and transferred 1/5 to Ann, 4/5 of the previously taxed property was donated to charity and 1/5 was transferred to Ann.

Because 4/5 of the previously taxed property is being donated to charity and, therefore, already being deducted from Bob's estate in computing its estate tax liability, a PTP credit should not be allowed with respect to that portion of the property. It is only the 1/5 being transferred to Ann that should be entitled to a credit if it is not to be taxed twice. The rest of her bequest is being funded by Bob's other assets, which have not been previously subjected to estate taxation. One-fifth of the previously taxed property ($2,000,000) multiplied by the tax rate (35%) equals $700,000 — the same credit amount calculated using the formulas in Regulation section 20.2013-3.

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$$\begin{array}{c} \text{40,000,000 (Charitable} \\ \text{deduction otherwise} \\ \text{allowable)} \end{array} \times \frac{\text{10,000,000 (Value of transferred property)}}{\begin{array}{c}\text{50,000,000 (Value of gross estate minus} \\ \text{expenses, losses, taxes and indebtedness)}\end{array}} = \begin{array}{l} \text{8,000,000 (amount} \\ \text{charitable} \\ \text{deduction must be} \\ \text{reduced)} \end{array}$$

$40,000,000 – $8,000,000 = $32,000,000 (adjusted charitable deduction allowed).

44 $50,000,000 (gross estate) - $40,000,000 (charitable deduction) x .35 (tax rate) - $1,772,800 (unified credit) - $700,000 (PTP credit).

IV. Sections 2056(d)(3) And 2013: Credit For Tax Paid By Qualified Domestic Trusts

As noted earlier, rather than enact a separate provision to govern the credit for estate tax imposed on a QDOT when it is also taxed in the second spouse's estate, Congress utilized the existing section 2013 PTP credit provision. Yet, because a QDOT is not taxed on its creation but generally only when the second spouse dies, the temporally limited PTP credit was somewhat inappropriate unless modified. Congress, therefore, made a few QDOT-specific modifications to the credit, to wit: (i) no requirement that the transferee/surviving spouse dies within ten years after, or within two years before, the transferor/first spouse's death; (ii) no percentage limitation of the credit for the time elapsed between the deaths; and (iii) a determination of the value of the QDOT property as of the date of death of the transferee/surviving spouse and not of the transferor/first spouse, since it is that value which is subjected to tax in both estates.[45]

Unfortunately, Congress and the Treasury Department failed to make one additional modification necessary to preserve the single-taxing event principle of the marital deduction — they failed to eliminate the application of the charitable deduction adjustment when applying Section 2013 to QDOTs. When applied to property passing in a QDOT, the charitable deduction adjustment precludes the surviving spouse from receiving appropriate credit for the estate taxes paid by the first spouse's estate when the surviving spouse leaves part of his or her estate to charity. As a result, in such circumstances, both spouses' estates are required to pay taxes on at least a portion of the QDOT property. This is exactly the type of double taxation Congress intended to prevent in its creation, and expansion, of the marital deduction.[46]

The double taxation of marital property cannot be justified as furthering the purpose of the charitable deduction adjustment, at least when applied to QDOTs that are QTIP Trusts (i.e., where the surviving spouse has no control over the disposition of the transferred assets). As discussed earlier, the purpose of the charitable deduction adjustment is to prevent a windfall to the transferee's estate by reducing the credit by

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[45] I.R.C. § 2056(d)(3); Treas. Reg. § 20.2056A-7(a)(2).

[46] *See supra* notes 5-6 and accompanying text. Congress did not intend for the QDOT to lead to the double taxation of marital property. *See* H.R. Rep. No. 100-795, pt. 2, at 592 (1988) ("*[I]n order to prevent taxation of the same property in both spouse's estate* [sic], the committee believes it is appropriate to provide a previously taxed property credit if the surviving spouse is subsequently subject to U.S. tax on his or her worldwide estate." (emphasis added)).

the portion of the tax on the previously taxed property that is presumed to have been bequeathed to charity by the transferee.[47]

However, in the case of a QDOT where the surviving spouse/transferee has no control over the disposition of the property, the charitable deduction adjustment is untenable.[48] The property that passes through such a QDOT is not commingled with the surviving spouse's other assets. No portion of the QDOT property is used to fund any charitable bequest made by the surviving spouse. No portion of the surviving spouse's estate's charitable deduction can be allocated to previously taxed property. Instead, the property simply passes from the QDOT to the beneficiaries chosen by the first spouse, and the surviving spouse's charitable bequest is funded solely with his or her own assets. As such, the charitable deduction adjustment only causes the inequitable double taxation of marital property.

> Consider the following example:
> Jack, a U.S. citizen, died in 2011 with a gross estate of $50,000,000. Under Jack's Will, he bequeathed $10,000,000 to a QDOT for the benefit of his wife, Jill, who was a U.S. resident but not a U.S. citizen. Upon Jill's death the QDOT property passes to Adam, Jack's only child from a previous marriage. Jill died in 2012. At the time of her death, Jill was still a U.S. resident and the value of the QDOT property was $10,000,000. There were no distributions of QDOT principal during Jill's lifetime. Jill's gross estate less deductions for expenses, indebtedness, taxes, losses, etc. was $50,000,000, which included the value of the QDOT. In her Will, she bequeathed the entire non-QDOT portion of her estate, $40,000,000, to charity.

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[47] *See supra* note 40 and accompanying text. This is a presumption only. No tracing of the previously taxed property into the estate of the transferee, and then from the estate to the charity, is required.

[48] The QTIP Trust itself was established because of the rising divorce and remarriage rates and Congress's increasing concern "with the difficult choice facing those in second marriages, who could either provide for their spouse to the possible detriment of the children of a prior marriage or risk under-endowing their spouse to provide directly for the children." Estate of Shelfer v. Comm'r, 86 F.3d 1045, 1049 (11th Cir. 1996). Because QTIP Trusts are used for such a situation — i.e., where the first spouse would like to provide for a surviving spouse and other individuals who may not be the beneficiaries of the surviving spouse's estate — it follows that QDOTs prepared like QTIP Trusts have a similar aim.

Jack's Estate

Under sections 2056A(b)(1)(B) and (b)(2)(A), Jack's estate would owe $3,500,000 in estate taxes as a result of the $10,000,000 of QDOT property being included in his estate on Jill's death.[49]

Jill's Estate

Because the QDOT property is included in Jill's gross estate, Jill would receive a credit for taxes paid by Jack's estate on the QDOT property. The QDOT credit is calculated under the Regulations as follows:

First Limitation

For QDOTs, rather then using the formula set forth in Regulation section 20.2013-2, the First Limitation simply equals the amount of estate tax that is imposed on the first spouse's estate with respect to the QDOT property.[50] Thus, the First Limitation here is $3,500,000.

Second Limitation

The Second Limitation is calculated as follows:

Estate tax imposed on Jill's estate, where the estate includes the value of the QDOT property and no section 2013 credit:

Gross estate, minus expenses, losses, etc.	$50,000,000
Less: Charitable Deduction	40,000,000
Taxable Estate	10,000,000
Estate tax	3,480,800
Less: Unified Credit	1,772,800
Estate tax	$1,708,000

Estate tax imposed on Jill's estate, where the estate does not include the value of the QDOT property, and the charitable deduction is reduced:

Gross estate, minus expenses, losses, etc.	$40,000,000
Less: Adjusted Charitable Deduction	32,000,000
Taxable estate	8,000,000
Estate tax	2,780,800
Less: Unified Credit	1,772,800
Estate tax	$1,008,000

49 Value of the QDOT property at time of Jill's death ($10,000,000) x .35 (tax rate in 2011 - year of Jack's death). *See* I.R.C. § 2056A(b)(1)(B)-(2)(A).

50 *See* Treas. Reg. § 20.2056A-7.

Thus, the Second Limitation equals $700,000 ($1,708,000 - $1,008,000).

Credit to Jill's Estate

Jill's estate would be entitled to a QDOT credit of $700,000, which is the smaller of the First and Second Limitation amounts. As a result, Jill would owe $1,008,000 in estate taxes, even though her entire estate passes to charity.[51]

As this example demonstrates, when the estate of a surviving spouse who is the income beneficiary of a QDOT makes a charitable bequest, the application of the charitable deduction adjustment results in the double taxation of some, or even all, of the QDOT property. Even though Jack's estate is taxed at the full 35% tax rate on the $10,000,000, for a tax owed of $3,500,000, Jill's estate is further taxed in the amount of $1,008,000 as a result of the inclusion of the QDOT property in her gross estate. As a result, the marital unit is taxed an extra $1,008,000 on the QDOT property. This result clearly undermines the intent of the marital deduction.

In fact, because Jill is giving her entire distributable estate to charity, her estate would actually be taxed *more* than Bob's estate (from the previous example), $10,000,000 of which is passing to his sister Ann. Since Jill's estate has no control over the QDOT property, the taxes would have to be paid out of the assets over which she does have control (i.e., the assets intended to pass to charity), resulting in a complex circular calculation that actually *increases* the estate tax liability and *decreases* the charitable bequest. The $1,008,000 in taxes Jill's estate would owe would have to be paid from the $40,000,000 charitable bequest, leaving only $38,992,000 in the estate to pass to charity. Then, because the charitable deduction would now be reduced to $38,992,000, $1,008,000 would be added to the taxable estate, so the estate tax would again increase, to approximately $1,290,240. The additional $282,240 in taxes would also have to be paid from the amount intended to pass to charity, once again reducing the charitable bequest and increasing the taxable estate. The cycle continues to repeat itself until, ultimately, Jill's estate would owe approximately $1,373,333 in estate tax, reducing her charitable donation by the same amount, to $38,626,667.[52] Thus, the application of the charitable deduction adjustment reduces the amount passing to charity by $1,373,333, and in the process contravenes the purpose of both the charitable and the marital deductions.

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51 $50,000,000 (gross estate) - $40,000,000 (charitable deduction) x .35 (tax rate) - $1,772,800 (unified credit) - $700,000 (QDOT credit).

52 This also means that the marital unit is actually taxed an extra approximately $1,373,333 on the QDOT property, instead of $1,008,000.

V. Conclusion

Although the QDOT was designed to make qualifying for the marital deduction more difficult for married couples where one spouse is not a U.S. citizen, it was still intended to give those couples the benefits of one-time taxation of marital property provided the more stringent QDOT standards were met.[53] Much like the rest of the Code, the method by which Congress sought to achieve this end was by the creation of a complex statutory and regulatory scheme difficult for even the most experienced tax professionals and practitioners to understand.[54] The scheme was so complex, however, that Congress and the Treasury Department failed to notice a clear anomaly in its final formulation — the inappropriate charitable deduction adjustment.

By requiring the estate of a surviving spouse to make a charitable deduction adjustment in calculating the credit for estate taxes paid by the first spouse's estate on QDOT property, Congress and the Treasury Department have imposed double taxation on property that passes in a QDOT, and, if some of the additional taxes have to be paid from the portion of the second estate passing to charity, have reduced the amount passing to charity, which is instead redirected to the Treasury in the form of these additional taxes. Given the clear purposes behind the marital deduction and the charitable deduction, such a result undoubtedly was not intended by Congress in enacting the QDOT provisions of the Code, or by the Treasury Department in formulating the Regulations. The Regulations must therefore be amended so as to eliminate the application of the charitable deduction adjustment to the QDOT credit in order to carry out these purposes.[55]

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[53] *See supra* note 46.

[54] The QDOT credit is a perfect example of the unnecessary complexity of the Code and Regulations. Although the provisions establishing and governing the QDOT itself can be found in section 2056A, the provisions for the QDOT credit are set forth in section 2056(d)(3). However, despite this fact, the Regulations to 2056A, and not 2056, set forth the parameters of the QDOT credit. *See* Treas. Reg. § 20.2056A-7.

[55] *See* I.R.C. § 2056A(e) ("The Secretary shall prescribe such regulations as may be necessary or appropriate to *carry out the purposes of this Section* . . . ." (emphasis added)); *see also, e.g.*, Snowa v. Comm'r, 123 F.3d 190 (4th Cir. 1997); Schudel v. Comm'r, 563 F.2d 1300 (9th Cir. 1977). As discussed in note 54, *supra*, since the QDOT-specific modifications to the PTP credit are set forth in Regulation section 2056A-7, any elimination of the charitable deduction adjustment to the QDOT credit would presumably be provided for in that Regulation.