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# STEP JOURNAL (/journal)

## Clear and present danger

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Lauren E Jones and J Andrew P Stone explain that, after a long delay, the US has issued proposed regulations on tax on gifts and bequests from covered expatriates.

### Key points

**What is the issue?** The US recently issued proposed regulations that clarify when and to whom gifts and bequests from a covered expatriate are taxable.

**What does it mean for me?** US recipients of gifts or bequests from a covered expatriate may soon owe 40 per cent in US tax on gifts and bequests received on or after 17 June 2008.

**What can I take away?** Even after expatriation, gifts and bequests from a covered expatriate to a US person are generally taxable by the US.

On 10 September 2015, the US Internal Revenue Service (IRS) issued proposed regulations concerning the tax on certain gifts and bequests from so-called 'covered expatriates',<sup>1</sup> pursuant to §2801 of the US *Internal Revenue Code*. The proposed regulations come seven years after the enactment of §2801.

# Background

Prior to §2801's enactment, US expatriates were subject to US gift and estate tax for, at most, a ten-year period following their expatriation. Accordingly, a US expatriate could avoid US estate tax by merely surviving for ten years. Congress enacted §2801 in an effort to level the playing field between US expatriates and US citizens and domiciliaries, who are subject to US gift and estate tax on their worldwide assets. Section 2801 imposes a tax equal in rate to the US gift and estate tax (currently 40 per cent) on virtually any gift or bequest from a covered expatriate to a US citizen or resident individual, US trust, or non-US trust that has elected to be treated as a US trust for the purposes of §2801 (collectively, 'US persons'). Section 2801 applies to gifts and bequests made by a covered expatriate on or after 17 June 2008 or the covered expatriate's date of expatriation.

Notably, however, §2801 does not contain a mechanism for paying this tax. Accordingly, while any covered gift or bequest made on or after 17 June 2008 is potentially taxable under §2801, to date it has not been possible to pay the tax. The proposed regulations clarify not only when and to whom gifts and bequests are taxable, but also create a mechanism for paying the §2801 tax.

## Definition of covered expatriate

A covered expatriate is any individual who gave up their US citizenship or long-term residency on or after 17 June 2008, and who:

- had an average US income tax liability that exceeded a certain threshold (for 2014, USD157,000) for the five years preceding their expatriation;

- had a net worth of USD2 million or more on their date of expatriation; or

- failed to certify that they had complied with all US federal tax obligations for the five years preceding expatriation.

## Taxable gifts and bequests under §2801

With limited exceptions, any direct or indirect gift by a covered expatriate to a US person is taxable under §2801. For example, if a covered expatriate makes a gift or bequest to a non-US trust and that trust subsequently makes a distribution to a US person, the distribution is taxable under §2801 to the extent it is attributable to the gift or bequest from the covered expatriate. If the non-US trust were to subsequently migrate to the US, it would likewise be taxable under §2801 to the extent of the gifts or bequests from the covered expatriate contained therein. The exercise, grant or release of a general power of appointment in favour of a US person is also taxable under §2801.

Prior to the proposed regulations' publication, it was unclear whether §2801 would apply to property acquired after the covered expatriate's date of expatriation. The proposed regulations confirm that it does. They also clarify that §2801 applies to a covered expatriate's gift or bequest to a US trust that qualifies as a charitable remainder trust, but not to the portion thereof attributable to the charitable remainder interest.

## Exceptions

Gifts and bequests that are already subject to US gift or estate tax are not taxable a second time under §2801. For example, a covered expatriate's gift of US real estate is already subject to US gift tax and, therefore, not taxable under §2801. Likewise, if a covered expatriate were to die a domiciliary of the US, their worldwide assets would be subject to US estate tax, not §2801 tax.

Additionally, gifts and bequests to a covered expatriate's US citizen or resident spouse or to charity are exempt, provided that they qualify for a US marital or charitable deduction. Notably, however, indirect gifts or bequests frequently do not qualify for these deductions. For example, if a covered expatriate makes a gift or bequest to a trust and that trust subsequently makes a distribution to the covered expatriate's US citizen or resident spouse, the distribution is taxable under §2801 unless the trust is a qualified terminable interest property (QTIP) trust or a qualified domestic trust (QDOT). Accordingly, it is possible for a covered expatriate to avoid the imposition of US tax on a gift or bequest to their spouse or to charity. However, planning is necessary.

Section 2801 also does not apply to transfers arising from a covered expatriate's qualified disclaimer of an interest in the transferred property.

## US generation-skipping transfer tax

The proposed regulations clarify that gifts and bequests from a covered expatriate are only subject to US generation-skipping transfer (GST) tax if they are otherwise subject to US gift or estate tax. For example, gifts and bequests of shares of stock of US corporations are subject to US gift and estate tax, whereas gifts and bequests of shares of stock of non-US corporations are not. Accordingly, a covered expatriate's gift or bequest of the former is subject to GST tax, whereas a gift or bequest of the latter is not.

## Tax liability

Under §2801, the US recipient of the gift or bequest is liable for the tax thereon. If the gift or bequest is made to a US trust or a non-US trust that has elected to be treated as a US trust for purposes of §2801, the trust is liable for the tax. Conversely, if the gift or bequest is made to a non-US trust that has not elected to be treated as a US trust for the purposes of §2801, the trust is not liable for the tax. On a subsequent distribution from the non-US trust to a US person, the US person is taxable under §2801 to the extent the distribution is attributable to a gift or bequest from a covered expatriate. In calculating the tax, the amount of gifts and

bequests from a covered expatriate are reduced by the amount of the annual exclusion (for 2015, USD14,000). The US recipient is also entitled to a credit for any gift or estate tax paid to a country other than the US with respect to the gift or bequest.

The US recipient is responsible for determining whether a gift or bequest is taxable under §2801. Notably, the proposed regulations authorise the IRS to disclose, in certain circumstances, to the US recipient the donor or decedent's return or return information. This disclosure provision is a new feature of the proposed regulations that was not in §2801. We anticipate that it will attract attention during the comment period for these regulations. For those for whom disclosure is an issue, it is important to be mindful of this provision.

The proposed regulations leave many questions unanswered with respect to the disclosure provision, the most important of which is when the IRS may disclose the donor or decedent's tax return or return information. Another is the consequence of non-disclosure. The proposed regulations state that the IRS will issue a bulletin addressing the former issue. They partially address the latter issue, providing that there is a rebuttable presumption that the donor is a covered expatriate if they are living and decline to authorise the disclosure of their relevant return or return information to the US recipient. The proposed regulations do not address the consequence of an estate declining to authorise disclosure.

## Payment of §2801 tax

The proposed regulations clarify that the §2801 tax is payable with a timely filed *Form 708, US Return of Gifts or Bequests from Covered Expatriates*. The IRS has yet to publish a draft of *Form 708*. Accordingly, US recipients of gifts or bequests from a covered expatriate will have to wait a little longer to pay their §2801 tax. For US recipients of distributions from non-US trusts, in particular, the long delay may prove a headache, as they will need to keep track of the extent to which each distribution is attributable to a gift or bequest from a covered expatriate to that trust, without necessarily having the requisite information to do so.

## Effective date

The effective date for the proposed regulations is the date of their publication in final form in the *Federal Register*. At the earliest, we anticipate this will be at the beginning of 2016, as comments are due on the proposed regulations on 9 December 2015, and a hearing is scheduled for 9 January 2016.

## Conclusion

After a long delay, the proposed regulations answered many questions that §2801 left unanswered, including, but not limited to, exactly when and to whom gifts and bequests from a covered expatriate are taxable, while still deferring the actual payment of tax. They also

created new questions, such as: in what circumstances is the IRS permitted to disclose the donor or decedent's tax return or return information? These questions will need to be answered in the final regulations or further IRS guidance.

1. Covered expatriates are generally high-income or high-net-worth individuals who gave up their US citizenship or long-term residency (i.e. 'green card') on or after 17 June 2008

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