

December 3 2015

## Tax on gifts and bequests from covered expatriates

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#### **Introduction**

On September 8 2015 the State Department announced that it would increase the fee for individuals to relinquish their US nationality and receive a certificate of loss of nationality from \$450 to \$2,350. This certificate addresses the immigration side of expatriation, but tax issues still remain. Certain 'covered' expatriates pay an exit tax on giving up their US citizenship. Although they themselves may have left the US tax net, there are lingering tax issues for any US family members. On September 10 2015 the Internal Revenue Service (IRS) issued proposed regulations concerning

the tax on certain gifts and bequests from covered expatriates. These proposed regulations come seven years after the enactment of the tax under Section 2801 of the Internal Revenue Code.

### **Relinquishment of nationality versus renunciation of citizenship**

The fee for relinquishing US nationality is now equal to the fee for renouncing US citizenship. The renouncement process involves a formal and intended written declaration that the individual is renouncing his or her US citizenship. Relinquishment, on the other hand, is an affirmation under oath regarding an action that the individual has taken with respect to acquiring another nationality. For example, at a US consulate the individual affirms that he or she, voluntarily and with the intent to relinquish US nationality, took an oath of allegiance to another country or voluntarily was naturalised in a foreign country. Regardless of the path taken to become an expatriate, an exit tax is levied on certain covered expatriates under Section 877A of the Internal Revenue Code. Covered expatriates are generally high-income or high-net-worth individuals who gave up their US citizenship or long-term residency on or after June 17 2008 (for further details please see the Overview (May 2014)). Section 2801 of the code imposes a tax on US individuals receiving gifts or bequests from such covered expatriates.

### **Tax on gifts and bequests from covered expatriates**

Before the enactment of Section 2801, US expatriates were subject to US gift and estate tax for at most a 10-year period following their loss of citizenship. Accordingly, an expatriate could avoid estate tax by merely surviving for 10 years. Congress enacted Section 2801 in an effort to level the playing field between US expatriates and US citizens and domiciliaries, who are subject to 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%) on virtually any gift or bequest from a covered expatriate to a US person, including a citizen or resident individual, US domestic trust or non-US trust that has elected to be treated as a US trust for purposes of Section 2801. Section 2801 applies to gifts and bequests made by a covered expatriate on or after the later of June 17 2008 or the covered expatriate's date of expatriation.

However, Section 2801 contains no mechanism for paying this tax. Accordingly, while any covered gift or bequest made on or after June 17 2008 is potentially taxable under Section 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 Section 2801 tax.

### **Direct and indirect gifts and bequests taxable under Section 2801**

With limited exceptions, any direct or indirect gift from a covered expatriate to a US person is taxable under Section 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 beneficiary, the distribution is taxable under Section 2801 to the extent that it is attributable to the gift or bequest from the covered expatriate. If the non-US trust were to subsequently migrate to the United States, it would likewise be taxable under Section 2801 to the extent that the trust property includes gifts or bequests from the covered expatriate. The exercise, grant or release of a general power of appointment in favour of a US person is also taxable under Section 2801.

Before the publication of the proposed regulations, it was unclear whether Section 2801 would apply to property acquired after the covered expatriate's date of expatriation. The proposed regulations confirm that it does. The proposed regulations also clarify that Section 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 of the gift or bequest attributable to the charitable remainder interest.

### **Exceptions for certain charitable and marital gifts and bequests**

Gifts and bequests from a covered expatriate that are already subject to US gift or estate tax are not taxable a second time under Section 2801. For example, any non-US individual's gift of US real estate is subject to US gift tax, and therefore not taxable under Section 2801 if that individual is a covered expatriate. Similarly, if a covered expatriate were to die a domiciliary of the United States, his or her worldwide assets would be subject to US estate tax, not Section 2801 tax (for further details please see the Overview (May 2014)).

In addition, gifts and bequests to a covered expatriate's US citizen or resident spouse or to charity are exempt, provided that they qualify for the marital or charitable deduction. 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 Section 2801 unless the trust is a qualified terminable interest property trust or a qualified domestic trust (for further details please see the Overview (May 2014)). Accordingly, with proper planning it is possible for a covered expatriate to avoid the imposition of US tax on a gift or bequest to his or her spouse or to charity.

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

#### **Application of generation-skipping transfer tax**

Gifts and bequests from a covered expatriate that are already subject to US gift or estate tax may also be subject to the US generation-skipping transfer (GST) tax, imposed on transfers to individuals two or more generations below that of the transferor, whether such transfer is made during life or at death (for further details please see the Overview (May 2014)). The proposed Section 2801 regulations clarify that gifts and bequests from a covered expatriate are subject to GST tax only if they are otherwise subject to US gift or estate tax. For example, a non-US person's gifts and bequests of US corporation stock are subject to US gift and estate tax (in the absence of an estate tax treaty exemption), whereas gifts and bequests of non-US corporation stock are not. Accordingly, a covered expatriate's gift or bequest of US corporation stock is subject to GST tax, whereas his or her gift or bequest of non-US corporation stock is not.

#### **Recipient liable to pay Section 2801 tax**

Pursuant to Section 2801, the US recipient of the gift or bequest is liable for the payment of the tax. 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 Section 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 purposes of Section 2801, the trust is not liable for the tax. On a

subsequent distribution from the non-US trust to a US beneficiary, the beneficiary is taxable under Section 2801 to the extent that 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 gift tax exclusion (\$14,000 for 2015 and 2016). The US recipient is also entitled to a credit for any gift or estate tax paid to a country other than the United States with respect to the gift or bequest.

### **Possible disclosure of expatriate's return information**

The US recipient is responsible for determining whether a gift or bequest is taxable under Section 2801. The proposed regulations authorise the IRS to, in certain circumstances, disclose 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 is not in Section 2801. It is anticipated that the disclosure provision will garner comments during the comment period for the Section 2801 proposed regulations. Families for whom disclosure is an issue should bear this provision in mind.

The proposed regulations left 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 he or she is living and declines to authorise the disclosure of his or her relevant return or return information to the US recipient. They do not address the consequence of an estate declining to authorise disclosure.

### **US return of gifts or bequests from covered expatriates**

The proposed regulations clarify that the Section 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 must still wait to pay their Section 2801 tax. For US recipients of distributions from non-US trusts in particular, the long delay may make payment more complicated 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. Publication of final regulations is anticipated in the beginning of 2016 at the earliest, as comments on the proposed regulations are due on December 9 2015 and a public hearing is scheduled for January 9 2016.

### **Comment**

After a long delay the proposed regulations answer many questions that Section 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 create new questions, such as the circumstances in which the IRS is permitted to disclose the donor or decedent's tax return or return information, which must be answered in the final regulations or further IRS guidance.

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