FOCUS ON
US AND CANADA
GIFTS FROM US EXPATRIATES

Beware expats bearing gifts

GIDEON ROTHSCILD EXPLAINS THAT US DONEES AND HEIRS FACE POTENTIAL TAX EXPOSURE FROM EXPATRIATES’ COVERED GIFTS AND BEQUESTS UNDER PROPOSED REGULATIONS

SECTION 301 OF the Heroes Earnings Assistance and Relief Tax Act of 2008 enacted sections 877A and 2801 of the US Internal Revenue Code, effective as of 17 June 2008. Among other provisions, the Code imposes a tax on US persons (citizens, resident alien domiciliaries and domestic trusts) who receive, directly or indirectly, gifts or bequests from a ‘covered expatriate’ (CE) in excess of the gift tax annual exclusion (currently USD14,000). Exceptions include the gift or bequest qualifying for a charitable or marital deduction or being reported on an estate or gift tax return filed by the transferor.

A CE is a US citizen or long-term permanent resident who relinquished citizenship or residency on or after 17 June 2008 and who meets a net-worth test of USD2 million, a net-income-tax-liability test, or who failed to certify compliance with US tax obligations for the preceding five years.

THE PROPOSED REGULATIONS
After almost eight years, proposed regulations were issued on 10 September 2015, and comments were submitted by a number of tax practitioners and professional organisations in January 2016. A new Form 708 will be released once the final regulations are issued and retroactive reporting for all gifts made since the effective date will be required, but no interest will be assessed prior to the due date specified in the final regulations.

Although the legislative history suggests that the intent of the statute was to make expatriation tax-neutral, the statute does not achieve this result. First, the tax is imposed at the highest estate or gift tax rate on the date of transfer, with a credit for any estate or gift tax paid to a foreign country. Second, unlike gifts or bequests by US domiciliaries, who get a lifetime exemption (currently USD5.45 million), gifts or bequests from CEs do not get any such exemption. Furthermore, it is irrelevant whether the transferred property was accumulated after the transferor’s expatriation date. Finally, the tax is imposed on the donee on a tax-inclusive basis.

AN EXAMPLE
If a US person makes a USD1 million gift, they will pay USD400,000 in gift tax (assuming they previously used their lifetime exemption) and the donee

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KEY POINTS

WHAT IS THE ISSUE?
US taxpayers who receive gifts or bequests from individuals who gave up their US citizenship or residency will be subject to a 40 per cent tax under rules recently proposed by the Internal Revenue Service. The proposed regulations implement §2801 of the Internal Revenue Code, which was added to the Code in 2008 by the Heroes Earnings Assistance and Relief Tax Act of 2008, to tax gifts and bequests.

WHAT DOES IT MEAN FOR ME?
STEP members who advise expatriates or their family members need to be aware of these rules, so that they can assist clients with efforts to minimise the tax effects.

WHAT CAN I TAKE AWAY?
With proper advance planning, members can help their clients avoid or minimise the harsh results of these rules.
A REVIEW OF THE 12TH ANNUAL INTERNATIONAL ESTATE PLANNING INSTITUTE

Why would over 300 professionals from approximately 25 countries and 20 US states gather in New York City just before a major US tax deadline to spend two days at a conference on estate planning? The answer: to learn from leading tax and estate-planning professionals.

The speaker line-up at the 12th Annual International Estate Planning Institute included the great and good from the estate-planning world, such as Donald Kozusko TEP and Stanley Barg TEP of Kozusko Harris Duncan, who led the session on foreign trusts; Emma White TEP and Warren Whitaker TEP, who discussed issues in UK-US estate and tax planning; Wendy Battelson of Art Strategy Partners, who opened delegates' eyes to international art collecting; and Chris Byrne, Paul Hocking TEP and Iain Younger, who gave a somewhat tongue-in-cheek session on US and foreign reporting to the Internal Revenue Service.

Attendees Maria Canals de Cidell, Attorney-at-Law and Managing Director at Delvest, Zurich, said: "I was impressed at the in-depth discussion of the various topics in the programme and the quality of the hand-out materials."

Gideon Rothschild and Stanley Barg held a session, on which this article is based, on the proposed regulations on gifts by expatriates and other new developments.

A full review can be found online. Please head to: bit.ly/1MHhISY

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will receive USD1 million. If, on the other hand, a CE makes a USD1 million gift, the tax is paid by the donee, who thus receives only USD600,000 of the tax paid, an effective rate of 67 per cent.

TRANSFERS

Unlike in the case of transfers by US persons, the filling requirement and tax payment obligation is imposed on the recipient of the gift or bequest. If a transfer is made to a domestic trust, the trust will file and pay the $2,801 tax. If the transfer is made to a foreign trust that elects to be treated as a domestic trust (an electing foreign trust), the $2,801 tax will be paid by such trust. The election to be treated as a domestic trust applies solely for $2,801 purposes and will not convert a foreign trust into a domestic trust for any other purpose. Once the election is made, the trustee must file Form 706 annually to report and pay the tax on all covered gifts or bequests, or certify that there were no such gifts or bequests received during that year.

If the foreign trust does not make the election, then a subsequent transfer from the foreign trust to a US person will result in the $2,801 tax being imposed on the beneficiary on that portion of the distribution attributable to covered transfers. The proposed regulations request comments specifically on how such amounts will be determined. It should be noted that, if a US citizen spouse receives an indirect transfer from a non-electing foreign trust, the marital deduction does not protect such distribution from the $2,801 tax, whereas a transfer to a domestic trust that qualifies for the marital deduction would not be subject to tax until the spouse's death.

One of the difficulties with the regulations, as issued, is that there is a rebuttable presumption that the transfer is from a CE if the donor does not authorise disclosure of their return information. The proposed regulation allows the donee/recipient to file a protective return to begin the running of the statute of limitations for assessment of the tax. In that event, if the Internal Revenue Service has information that the donor was a CE, it could assess the tax accordingly.

One exception is where the CE (or their estate) files a timely gift tax (or estate tax) return and pays the tax. This would be the case where the tax is of US situs assets. But, if the return or payment is not timely, the recipient is obligated to pay the tax as well, in which case it is likely that the tax will be paid twice on the same transfer without any relief provided for in the regulations. Finally, unlike the case with a US person paying gift tax and being allowed a basis increase for such tax paid, there is no similar provision allowing for a basis increase for the $2,801 tax paid.

PLANNING CONSIDERATIONS

To minimise the exposure to this tax, the client who expects to expatriate should consider a number of planning strategies, unless the CE's entire family expatriates with them. The client can settle an irrevocable insurance trust to own life insurance policies on their life, utilise their lifetime exemption prior to expatriating, and engage in other estate-planning strategies to avail themselves of valuation discounts for lack of control and marketability. Transferees may wish to consider expatriating prior to receipt of a gift or bequest.

One favourable distinction from transfers made by US persons is that a transfer by a CE, of non-US situs assets, will not be subject to the additional generation-skipping transfer tax, which would suggest that such covered gifts or bequests be made in trust so as to avoid tax on subsequent transfers to younger generations. Note that, if the transfer is of US situs assets and thus subject to the gift or estate tax, it will also be subject to the generation-skipping transfer tax.

CONCLUSIONS

Though the number of taxpayers who are, or will become, CE's is probably relatively small, the $2,801 tax will require all US practitioners to become familiar with the reporting requirements to avoid potentially significant penalties. Those clients who seek out advice on pre-immigration planning (e.g. so as to avoid green card status) and pre-expatriation estate-planning strategies will be able to weather the consequences best. Only time will tell how much revenue will be gained from this new source.

1 In addition to the $2,801 tax, such a distribution to a US person will also carry out the distributable net income (DNI) and any accumulated income subject to income tax and the accumulation penalty. Although the statute does allow an income tax deduction for the $2,801 tax, it is possible that the total tax could exceed the amount received.