



The *WRMarketplace* is created exclusively for AALU members by the AALU staff and Greenberg Traurig, one of the nation’s leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

Thursday, 25 February 2016

WRM # 16-08

TOPIC: The Tax on Gifts and Bequests from Covered Expatriates.

MARKET TREND: As more U.S. citizens and long-term permanent residents expatriate, an increasing number of U.S. family and friends who receive gifts and bequests from these expatriates will incur new taxes under Internal Revenue Code (“Code”) § 2801.

SYNOPSIS: In 2008, Congress passed legislation that imposes a tax under Code § 2801 on U.S. recipients of certain gifts and bequests from individuals who have relinquished their U.S. citizenship or long-term permanent residency in the U.S. (so-called “Covered Expatriates”). This tax applies at the maximum estate and gift tax rate (currently 40%), and recipients are only allowed an annual exemption equal to the gift tax annual exclusion (currently \$14,000) against the total covered gifts and bequests received each year. Although the tax has not yet been implemented, the IRS has issued proposed regulations that will provide much needed guidance regarding its application. Once the regulations are published as final, U.S. recipients will need to file a new Form 708, U.S. Return of Gifts or Bequests from Covered Expatriates, to report any gifts and bequests received from a Covered Expatriate since June 17, 2008.

TAKE AWAYS: Advisors who have clients that are planning to expatriate can play a key role in assisting them with pre-immigration planning to navigate the Code §2801 tax after the date of expatriation. Many recipients of covered gifts and bequests

are also likely unaware of this tax and their duty to report and pay the liability. Going forward, educating clients regarding the tax and evaluating whether a reporting obligation exists will be critical.

MAJOR REFERENCES: *Code § 2801; Proposed Treas. Regs. § 28.2801.*

In 2008, as part of the Heroes Earnings Assistance and Relief Tax Act,¹ a new income, estate, and gift tax regime was introduced for certain U.S. citizens and long-term permanent residents who expatriate from the U.S. (“**Covered Expatriates**”). This legislation also added Code § 2801, which imposes a tax on U.S. recipients of certain gifts or bequests from a Covered Expatriate (collectively referred to in this article as “**Covered Transfers**”). These transfers otherwise would have escaped U.S. gift and/or estate taxes due to the expatriation.

More than seven years after the enactment of Code § 2801, the IRS has issued proposed regulations that, when finalized, will provide much needed guidance with respect to the application of the tax imposed under Code § 2801 (“**2801 Tax**”), particularly for those clients who have received Covered Transfers but have not yet paid the tax.

EFFECTIVE DATE & NEW FORM

The proposed regulations will be effective only after they are adopted and published in final. Thereafter, the IRS will release a new Form 708, U.S. Return of Gifts or Bequests from Covered Expatriates (“**Form 708**”), to report Covered Transfers and calculate the 2801 Tax liability. Under the proposed regulations, Form 708 will be due on or before the 15th day of the 18th calendar month following the close of the calendar year in which the Covered Transfer is received², giving most U.S. recipients ample time to gather the information necessary to file the return. U.S. recipients who receive Covered Transfers before the final regulations are published will be given a reasonable period of time to file the Form 708 and pay the 2801 Tax.³

- ✓ **Practice Point.** Clients who received a Covered Transfer on or after June 17, 2008 and before the publication of the final regulations will still be required to file the new Form 708 to report these transfers and pay the 2801 Tax. It will be very important for clients to be prepared to file the return when it is due to avoid interest and penalties on the unpaid tax.

TAX RATE & EXEMPTION

The 2801 Tax is assessed at the highest gift or estate tax rate in effect at the time of the Covered Transfer (currently 40%). Upon expatriation, Covered Expatriates no longer have the unified estate and gift tax exemption allowed to U.S. donors or decedents to offset the gift or estate tax applicable to gifts or bequests. Instead, the U.S. recipient of a Covered Transfer is allowed a new “**2801(c) amount**” (equal to the gift tax annual exclusion (currently \$14,000)), which is applied against the total amount of Covered Transfers received during the year.⁴

Example: In 2014, T, a U.S. citizen, received a \$100,000 gift from A and a \$150,000 bequest from B (both are Covered Transfers). The highest estate and gift tax rate is 40% and the 2801(c) amount is \$14,000. T computes his 2801 Tax for 2014 by multiplying his net Covered Transfers by 40%. T’s net Covered Transfers are \$236,000 (2014 total Covered Transfers (\$250,000) - 2801(c) amount (\$14,000)). T’s 2801 Tax liability for 2014 is \$94,400 (\$236,000 x 40%) (less any foreign estate or gift tax paid by T, A, or B on the Covered Transfers).

- ✓ **Practice Point.** For a client who plans to expatriate and would be deemed a Covered Expatriate, consideration should be given to using the client’s remaining lifetime gift tax exemption before it is lost, such as using the exemption to create and fund an irrevocable life insurance trust (“ILIT”) or a dynasty trust.

WHO IS SUBJECT TO THE 2801 TAX?

Unlike traditional gift and estate taxes which are imposed on donors or estates, the 2801 Tax is imposed on the recipients of Covered Transfers, if the recipients are U.S. citizens or residents (“U.S. recipients”).⁵ Note that, for this purpose, the proposed regulations determine U.S. residency under the estate and gift tax rules, which apply a subjective domicile test (rather than the objective number of days present in the U.S. test generally used to determine income tax residency).⁶ Under the domicile test, a non-citizen is a U.S. resident if the individual is physically present in the U.S with the intention to remain indefinitely.

Example: T is a citizen of France, currently living in the U.S. on a Visa. T intends to remain in the U.S. indefinitely and has established a U.S. domicile. T is deemed to be a U.S. resident under the gift and estate tax rules of the Code. Covered Transfers to T, while he is domiciled in the U.S., will be subject to the 2801 Tax.

Domestic trusts and foreign trusts that elect to be treated as domestic trusts for purposes of Code §2801 (a so-called “**electing foreign trust**”), that receive Covered Transfers also are subject to the 2801 Tax.⁷

WHO IS A “COVERED EXPATRIATE”?

Whether a gift or bequest is a Covered Transfer subject to the 2801 Tax depends on whether the donor or decedent is a Covered Expatriate. An individual is a Covered Expatriate if:

- The individual relinquished U.S. citizenship or long term permanent resident status on or after June 17, 2008, **and**
- On the expatriation date, the individual meets one of the following requirements:
 - Has an average annual net income tax liability greater than \$124,000 (indexed annually for inflation (\$161,000 for 2016)) for the previous five taxable years,
 - Has a net worth of at least \$2,000,000 (net worth is not indexed for inflation), **or**
 - Fails to certify, under penalty of perjury, that he or she has complied with all U.S. tax obligations for the five preceding taxable years.⁸

Under the proposed regulations, the U.S. recipient of a Covered Transfer is responsible for determining whether the 2801 Tax applies.⁹ Accordingly, the U.S. recipient has the burden of determining (i) whether the donor or decedent was a Covered Expatriate and, if so, (ii) whether the gift or bequest was a Covered Transfer (discussed below). The IRS has acknowledged that it may be difficult for U.S. recipients to obtain the information necessary to make these determinations from the expatriate or other reliable source. Procedures will be implemented to authorize the IRS to disclose an expatriate’s gift or estate tax return or information (subject to the expatriate’s consent if living) to assist the U.S. recipient in making the determinations.

Not all living expatriates may be willing to allow the IRS to release the relevant return or information. In such cases, the U.S. recipient is presented with a rebuttable presumption that the expatriate is a Covered Expatriate and that each gift from that expatriate to the U.S. recipient is a Covered Transfer. If the U.S. recipient reasonably concludes, after exercising due diligence, that a gift or bequest is not subject to the

2801 Tax, he or she may file a protective Form 708 to rebut the presumption and start the limitations period for assessment of the 2801 Tax.¹⁰

- ✓ **Practice Point.** Clients who have received a gift or bequest from an expatriate should start collecting information from the expatriate or his or her estate now to determine whether the gift/bequest is subject to the 2801 Tax. Note that anyone who expatriated before June 17, 2008 is not a Covered Expatriate.

WHAT GIFTS & BEQUESTS ARE COVERED TRANSFERS UNDER CODE §2801?

The 2801 Tax is imposed only on “covered gifts and bequests,”¹¹ which generally means any assets acquired directly or indirectly from a Covered Expatriate, by gift or by reason of the Covered Expatriate’s death (e.g., any assets that would be included in the expatriate’s gross estate if he or she had been a U.S. citizen), regardless of the situs of such property or whether the property was acquired by the Covered Expatriate before or after expatriation from the U.S.

Example: X is a Covered Expatriate residing in the Bahamas. Her son, T, is a U.S. citizen who also resides in the Bahamas. X gives T 10,000 shares of IndiaCo, Inc., a company incorporated in India, which X acquired after her expatriation. The gift to T is a Covered Transfer, as a covered gift, and subject to the 2801 Tax.

Distributions to a U.S. recipient from a foreign trust that has not elected to be treated as a domestic trust for purposes of Code § 2801 (a so-called “**non-electing foreign trust**”) are also Covered Transfers that are subject to the 2801 Tax, but only to the extent the distributions are attributable to gifts or bequests made by a Covered Expatriate to the non-electing foreign trust.¹² The term “distribution” is broadly defined to include any direct, indirect, or constructive transfer from a foreign trust, including each disbursement made pursuant to the exercise, release, or lapse of a power of appointment.¹³

The proposed regulations include several exceptions to these definitions, including as follows:

- *Taxable Gifts and Bequests.* Taxable gifts reported by a Covered Expatriate on a timely filed U.S. gift tax return and property included in a Covered Expatriate’s U.S. gross estate and reported on a timely filed U.S. estate tax return are not Covered Transfers as long as the gift or estate tax due is timely paid.¹⁴

Example: X, a Covered Expatriate domiciled in Australia, owns a U.S. residence, which he acquired before his expatriation in 2010. X died in 2014, leaving the property to his son, S, a U.S. citizen. The residence is included in X's gross estate for U.S. estate tax purposes. The executor of X's estate timely filed a U.S. estate tax return and paid the applicable estate taxes. Accordingly, the bequest to S is not subject to the 2801 Tax. (Note, however, that if the executor had not timely filed the return or paid the estate tax due, the bequest would be subject to the 2801 Tax.)

- *Disclaimers and Charitable Donations.* A qualified disclaimer made by a Covered Expatriate is not a Covered Transfer. Further, charitable donations that would qualify for the estate or gift tax charitable deduction also are exceptions and do not constitute Covered Transfers.¹⁵
 - *Transfers to a Spouse.* A gift or bequest to a Covered Expatriate's spouse who is a U.S. citizen or resident is not a Covered Transfer provided the gift or bequest would qualify for the gift or estate tax marital deduction if it had been given by a U.S. citizen or resident. This generally means that a gift or bequest in trust must qualify for the estate or gift tax marital deduction as a qualified terminable interest property ("QTIP") trust or a qualified domestic trust ("QDOT").¹⁶
- ✓ **Practice Point.** Note that gifts to a spouse who is a U.S. resident but not a citizen are still subject to the annual limit under Code § 2523(i) (\$100,000 per year as indexed annually for inflation (\$148,000 for 2016)). Gifts that exceed this amount will be Covered Transfers subject to the 2801 Tax.

WHO MUST PAY THE 2801 TAX?

As discussed above, the 2801 Tax is paid by the U.S. recipient of the Covered Transfer. The proposed regulations provide specific rules regarding who is liable for payment of the tax.

Individuals and Domestic Trusts. Generally, an individual U.S. recipient of a Covered Transfer is liable for payment of the tax.¹⁷ If a domestic trust receives a Covered Transfer, the trust is treated as a U.S. citizen and liable for payment of the 2801 Tax rather than the beneficiaries.¹⁸

Foreign Trusts. An electing foreign trust is treated as a U.S. citizen and is liable for payment of the 2801 Tax. However, a non-electing foreign trust is not liable for the

2801 Tax.¹⁹ Instead, each U.S. recipient of a distribution from the non-electing foreign trust is liable for payment of the tax (to the extent the distribution is attributable to Covered Transfers to that trust).

- ✓ **Practice Point.** As indicated above, the 2801 Tax rate is 40%. Clients receiving Covered Transfers will need to reserve adequate funds for payment of the tax liability.

PLANNING CONSIDERATIONS AND OPPORTUNITIES

Code § 2801 provides both planning opportunities and pitfalls for current and future U.S. taxpayers. Although the proposed regulations define Covered Transfers quite broadly, some traditional estate planning techniques should still be useful to Covered Expatriates, including ILITs, annual gifts that are under the 2801(c) amount (generally equal to the gift tax annual exclusion of \$14,000), installment sales to grantor trusts, leveraging gifts through the use of available discounts and marital and charitable deduction planning.

- ✓ **Practice Point.** Annual Crummey withdrawal powers equal to the 2801(c) amount should still be a viable funding tool for an ILIT. Care will need to be taken to ensure each holder of a Crummey withdrawal power does not receive total Covered Transfers during the year in excess of the 2801(c) amount (\$14,000 in 2016).

U.S. citizens and long-term permanent residents contemplating expatriation will need to consider whether pre-expatriation gifts should be made to U.S. recipients to take advantage of the lifetime gift tax exemption (\$5,450,000 in 2016) and reduce the impact of the 2801 Tax on post-expatriation gifts and bequests. Such gifts made to an ILIT could be leveraged through the acquisition of a policy insuring the life of the soon-to-be expatriate.

A U.S. citizen who expects to receive a large Covered Transfer may wish to relinquish his or her citizenship before receipt. Similarly, a U.S. resident who anticipates receiving a large Covered Transfer may wish to relinquish his or her visa or green card or establish his or her domicile in another country before receiving the gift or devise. Distributions from a foreign trust or estate could be deferred until such changes in status are completed.

Example: T, age 19, is a U.S. citizen. Both of T's parents expatriated in 2010 and are Covered Expatriates. T has lived with his parents outside of the U.S. since their date of expatriation. T has no other family or friends living in the U.S. T's parents would like to make a large gift to T. If T

expatriates prior to the gift, it would not be a Covered Transfer for purposes of Code § 2801.

A non-citizen, non-resident of the U.S. (“**NCNR**”) who plans to obtain a green card or seek U.S. citizenship also should consider the potential implications of Code §2801. If the NCNR does not plan to reside in the U.S. permanently, one of the U.S. visa programs may allow the NCNR to reside in the U.S. for the foreseeable future without triggering the 2801 Tax on Covered Transfers after leaving the U.S.

TAKE AWAYS

Advisors who have clients that are planning to expatriate can play a key role in assisting them with pre-immigration planning to reduce the impact of the Code §2801 tax after the date of expatriation. Many recipients of Covered Transfers also are likely unaware of this tax and their duty to report and pay the liability. Going forward, educating clients regarding the tax and evaluating whether a reporting obligation exists will be critical.

NOTES

TCO 361803010v3

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

WRM #16-08 was written by Greenberg Traurig, LLP

Jonathan M. Forster

Martin Kalb

Richard A. Sirius

Steven B. Lapidus

Rebecca Manicone

Counsel Emeritus

Gerald H. Sherman 1932-2012

Stuart Lewis 1945-2012

¹ Public Law 110-245 (122 Stat. 1624).

² Prop. Reg. § 28.6071-1(a).

³ Prop. Reg. § 28.6071-1(d).

⁴ Code § 2801(c).

⁵ Prop. Reg. § 28.2801-1.

⁶ Prop. Reg. § 28.2801-2(b).

⁷ *Id.* A foreign trust may elect to be treated as a domestic trust solely for purposes of §2801, in which case the 2801 Tax is imposed on the electing foreign trust when it receives a Covered Transfer, rather than when distributions are made from the trust to U.S. beneficiaries. The proposed regulations provide direction with respect to the time and manner of making a valid election and termination of the election.

⁸ Code § 2801(f), Prop. Reg. § 28.2801-2(h).

⁹ Prop. Reg. § 28.2801-7(a).

¹⁰ Prop. Reg. § 28.2801-7(b)(2).

¹¹ Code § 2801(a).

¹² Prop. Reg. § 28.2801-2(f)-(g).

¹³ Prop. Reg. § 28.2801-5(b).

¹⁴ Code § 2801(c)(2), Prop. Reg. § 28.2801-3(c)(1)-(2).

¹⁵ Code § 2801(c)(2), Prop. Reg. § 28.2801-3(c)(3) and (5).

¹⁶ Prop. Reg. § 28.2801-3(c)(4). Note that a non-electing foreign trust will not qualify for the gift or estate tax marital deduction, and that a distribution from such non-electing trust to the U.S. recipient spouse will be subject to the 2801 Tax.

¹⁷ Prop. Reg. § 28.2801-4(a)(1).

¹⁸ Prop. Reg. § 28.2801-4(b)(2).

¹⁹ Prop. Reg. § 28.2801-4(a)(3)(i).