
Covered Gifts & Bequests: The Need For Guidance (5+ Years Out)

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EXECUTIVE SUMMARY

This paper makes some suggestions for guidance under Section 2801, which has yet to be issued by the IRS and Treasury.

Section 2801¹ was passed into law in 2008 as part of the “HEART” Act.² In short, the statutory provision provides that “any United States citizen or resident” who receives “any covered gift or bequest”³ is subject to a tax (currently 40%⁴) on the value of such gift or bequest.

The IRS announced in 2009 that it would issue guidance, specifically including a new IRS Form 708 to report such gifts and bequests.⁵ No such form exists to date. The need for guidance is particularly acute for several reasons.

First, the collection of the tax has been suspended until after guidance is issued along with IRS Form 708.⁶ Second, this is the first U.S. federal tax of its kind as a true “inheritance” tax, in the case of bequests. It is also apparently the first tax of its kind on the recipient of gifts, which are otherwise exempt from income tax.⁷ Third, the IRS has no way to help effectively track the tax, its application, collection and general enforcement. Fourth, there is no basic guidance beyond the statute for “any United States citizen or resident” who receives such a gift or a bequest to make a host of decisions to properly determine or calculate the tax. Fifth, presumably no “United States citizen or resident” has ever even paid such a tax, due to its suspension; although the law is now almost six years old.

Sixth, the statute imposes no time requirement for when the tax must be paid. Seventh, since many of the assets likely to be gifted or bequeathed will be located outside the U.S. in different countries with different currencies and economic variables and legal systems compared to the U.S., there is a particular need to know the allowable methods of valuing the property gifted or bequeathed. Eighth, Chapter 4 of Subtitle A, FATCA will bring greater awareness of U.S. tax law requirements for U.S. citizens and residents living outside the U.S., specifically including Section 2801.

Ninth and finally, there have been a record number of U.S. citizens who have renounced or relinquished their citizenship during the year 2013, which increases the number of affected taxpayers who might receive covered gifts or bequests.⁸

DISCUSSION

I. BACKGROUND: HEART ACT AND COVERED BEQUESTS AND COVERED GIFTS

U.S. citizens and residents are taxed on their worldwide income, regardless of where they might physically live.⁹ A non-citizen meeting certain residency or lawful permanent residency (“LPR”) status is treated similarly to a citizen and is defined as a “resident”¹⁰ and hence a “U.S. person”¹¹ under the Internal Revenue Code.

The estate tax also applies to the worldwide assets of United States citizens, regardless of where they might physically reside.¹² Similarly, the U.S. gift tax applies to the worldwide assets of United States citizens, regardless of where they might physically reside.¹³ Gifts received by citizens and residents are generally exempt from U.S. income taxation.¹⁴

¹ A new Chapter 15 was created for Section 2801 (and no other section), within Subtitle B.

² The Heroes Earnings Assistance and Relief Act of 2008.

³ See, Section 2801(e) which generally defines a “covered gift or bequest” as property acquired directly or indirectly from an individual who is a “covered expatriate” as determined under Section 877A(g)(1). A “covered gift or bequest” excepts certain transfers otherwise subject to estate or gift tax (Section 2801(e)(2)) and certain transfers to a spouse or charity (Section 2801(e)(3)).

⁴ See, Section 2801(a)(1) that imposes the rate of tax specified in the table contained in Section 2001(c) or Section 2502(a), whichever is higher.

⁵ See, Ann. 2009-57; 2009-29 IRB 158.

⁶ *Id.*

⁷ See, Section 102(a).

⁸ See, *More Taxpayers Are Abandoning the U.S. Year's Tally for Expatriations Sets Record; Increase Comes Amid Tax Crackdown on Offshore Assets*, By, Laura Saunders (WSJ), Nov. 13, 2013.

⁹ See, IRC § 61 and Treas. Reg. §§ 1.1-1(b) and 1.1-1(a)(1).

¹⁰ See, Section 7701(b)(1)(A) and (b)(6).

¹¹ See, Section 7701(a)(30).

This system of worldwide taxation of estate and gift tax transfers¹⁵ based only upon citizenship, seems odd to many individuals and tax advisors in other countries; since the U.S. is apparently alone in its imposition of worldwide estate and gift taxation on U.S. citizens or “residents” if the individual is physically resident in a particular country (e.g., for a sufficient number of days).¹⁶

There are also a series of complications for the U.S. government in enforcing the U.S. tax regime against persons and assets located outside the U.S. In the case of covered bequests or gifts, it is possible the majority of them will be received by U.S. persons who reside exclusively outside the U.S. The 1998 Treasury Department study still has much relevance to this topic where it stated as follows (even though its focus was on Subtitle A and not Subtitle B):

Other factors also operate to limit both compliance measurement and improvement. Because the United States asserts taxing jurisdiction over those with little or no connection to the United States other than citizenship or status as a lawful permanent resident, in many cases overseas U.S. taxpayers are difficult to trace or contact. Moreover, even when valid tax assessments can be made against overseas taxpayers, IRS has limited enforcement recourse if the taxpayer’s assets are physically located outside of the United States. In addition, persons may be unaware of their status as U.S. taxpayers with an obligation to file a U.S. tax return. . . . For example, an individual who was born outside the United States and has never even visited the country may, nevertheless, be a U.S. citizen by reason of his parents’ U.S. citizenship. Such a person may not even know that he is a U.S. citizen and thus likely will not know of his obligation to file a U.S. tax return [for his or her estate’s obligation to file an estate tax return].¹⁷

The purpose of this proposal is to recommend various steps the Treasury and IRS can adopt to help make the law enforceable, and minimize confusion that currently exists for United States persons who receive these type of gifts or bequests. Concurrently, there is much confusion, including to what extent these U.S. persons may have exposure to tax penalties regarding such covered gifts and covered bequests.

1. “Covered” Bequests and Gifts Expands the U.S. Global Tax Reach

Section 2801 furthers the reach of the U.S. tax regime by imposing the 40% tax on U.S. citizens and “residents” residing outside the U.S., along with those living in the U.S.

Any covered gift or bequest¹⁸ means property that is received by a U.S. citizen or “resident” from a “covered expatriate,”¹⁹ i.e., a former U.S. citizen or a former long-term resident.²⁰ The tax is levied and paid by the U.S. citizen or resident who receives it, and not the donor or the estate.²¹ The only amounts exempted from the tax are (a) the annual exclusion amount of US\$10,000,

¹² See, Section 2001

¹³ See, Section 2501

¹⁴ See, Section 102(a).

¹⁵ See, Chapters 11 and 12 of Subtitle B of Title 26. See also, United States Congress Joint Committee on Taxation entitled Issues Presented by Proposals to Modify the Tax Treatment of Expatriation (U.S.G.P.O., June 1, 1995), <http://www.house.gov/jct/s-17-95.pdf>.

¹⁶ *Id.*, see, footnote 17 and Appendix B to the Joint Committee on Taxation report.

¹⁷ See, U.S. Treasury Report, dated May 1998; “Income Tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside the United State and Related Issues.” (1998), p. 14, <http://www.treasury.gov/press-center/press-releases/Documents/tax598.pdf>

¹⁸ See, Section 2801(e).

¹⁹ See, Sections 2801(f) and 877A(g)(1).

²⁰ See, subparagraphs (A), (B) and (C) of Sections 877(a)(2) defining a “covered expatriate” as a former U.S. citizen or “long-term resident” (a lawful permanent resident of the U.S. who had such status for at least 8 years of the last 15 taxable years) who meets one of three tests. These tests are: (A) average annual net income tax of US\$124,000; (B) net worth of US\$2M, or (C) fails to certify under penalty of perjury that the taxpayer has met the requirements of title 26 for the 5 preceding taxable years.

²¹ See, Section 2801(b).

indexed for inflation (currently US\$14,000)²² and certain qualifying transfers to a spouse or charity.²³ Importantly, the tax is reduced by the amount of any gift or estate tax paid to a foreign country with respect to the covered gift or bequest.²⁴

2. No Guidance Hinders and Delays the Collection of the Tax

The IRS has expressly stated it has suspended the collection of the tax until after guidance is issued along with an expected, but yet to be issued, IRS Form 708.²⁵ The longer the collection of the tax is suspended, the less likely it will be collected, particularly for U.S. citizens living outside the U.S.²⁶

II. PROPOSALS FOR GUIDANCE

1. Identify a Specific Date for When the Tax is Due (IRS Form 708)

The statute does not identify when the tax is due and hence payable by the U.S. citizen or resident. There are a number of different methods that could be used, with specific dates. Probably the least burdensome for taxpayers, is the due date of when U.S. individual income tax returns are due by the recipient of the covered gift or covered bequest. The tax return is generally due by April 15th;²⁷ or June 15th²⁸ for those U.S. citizens or residents residing outside the U.S.

These individuals must generally report large gifts and bequests from foreign persons with their U.S. individual income tax returns on IRS Form 3520.²⁹ Accordingly, a similar timing rule, particularly since the gift and bequest is already being reported, would be most logical. Providing a 16-month or 18-month period for defining “timely filed”, such as is set forth in the regulations under Treas. Reg. § 1.874-1(b) and 1.882-4(a)(3)(i) would provide a reasonable period of time. This would be consistent with other guidance and provide a reasonable opportunity for persons to even identify the existence of this tax.

Presumably, these due dates (for when IRS Form 708 is due and the tax is payable) would need to be identified in the form of regulations in light of *Home Concrete*³⁰ and *Mayo*³¹. Such a regulatory rule could be drafted along the lines of the regulatory rule upheld by *Swallows Holding, Ltd. v. Comm’r*.³²

2. How is the value of the gift or bequest to be determined (should estimates be permissible)?

One basic problem for any tax on a gratuitous transfer of an asset, is determining the value of the asset transferred. For instance, must appraisals be obtained by the taxpayer? Obviously, requiring appraisals necessarily increases the costs and burdens on the taxpayer.³³

The taxpayer should be expressly liable for any substantial undervaluation penalty per Section 6662(g). The statute expressly references any transfer in accordance with subtitle B (although reference is only made to “estate” and “gift” tax transfers. Therefore, the rationale and logic set forth by the government in implementing the collection of information with respect to

²² See, Section 2801(c) referencing the annual gift exclusion amount in Section 2503(b). This is a per year exclusion amount, which cannot be duplicated in a single year based upon the number of persons making such transfers, unlike the gift tax annual exclusion.

²³ See, Section 2801(e)(3) referencing amounts which are allowed a deduction under Sections 2055, 2056, 2522 or 2523.

²⁴ See, Section 2801(d).

²⁵ See, Ann. 2009-57; 2009-29 IRB 158.

²⁶ See, GAO/GGD-98-106 Nonfiling Among U.S. Citizens Abroad, which generally discusses the finding of U.S. citizens living outside the U.S. who do not file income tax returns; although Chapter 4 of FATCA will likely bring greater awareness to these persons of the U.S. tax law requirements, specifically including Section 2801.

²⁷ See, Section 2801(d).

²⁸ See, Treas. Reg. § 1.6081-5(a)(5).

²⁹ See, Treas. Reg. § 1.6081-5(a)(5).

³⁰ See, *United States v. Home Concrete & Supply, LLC* 132 S. Ct. 1836 (2012).

³¹ See, *Mayo Foundation For Medical Education & Research v. United States* 131 S.Ct. 1836 (2011).

³² See, 2008 U.S. App. LEXIS 3442 (3d Cir. 2008), regarding Treas. Reg. § 1.874-1(b) and 1.882-4(a)(3)(i).

³³ See, IRS Notice 97-19 regarding the 1996 amendments to Section 877, which provided formal appraisals were not required and good faith estimates were acceptable.

"foreign financial assets"³⁴ and IRS Form 8938, should be similarly applicable in this context. In that case, the IRS provided that estimates are permissible in those circumstances.³⁵ The same concepts that are adopted in temporary Treasury Regulations Section 1.6038D-5T Valuation guidelines, could be similarly adopted for the provisions in Section 2801.

The approach of not requiring formal appraisals provides a common sense and not overly burdensome method to help taxpayers comply with their tax and reporting obligations.

Since the taxpayer generally has the burden of establishing the correct value in response to a determination made by the IRS,³⁶ it will behoove the taxpayer to obtain an appraisal of the asset in those cases where the assets have a particularly high value or are otherwise complex to value. This incentive is compounded by a 20% substantial undervaluation penalty under Section 6662(g).

3. What other IRS Forms might have specific references or questions to the tax required under Section 2801?

As already discussed, IRS Form 3520 has a specific Part IV that provides where the taxpayer has to report the foreign gift or inheritance. See the relevant portion of the form below:

Form 3520 (2013) Page **6**

Part IV U.S. Recipients of Gifts or Bequests Received During the Current Tax Year From Foreign Persons
(see instructions)

54 During the current tax year, did you receive more than \$100,000 that you treated as gifts or bequests from a nonresident alien or a foreign estate? See instructions for special rules regarding related donors Yes No

If "Yes," complete columns (a) through (c) with respect to each such gift or bequest in excess of \$5,000. If more space is needed, attach a statement.

(a) Date of gift or bequest	(b) Description of property received	(c) FMV of property received
Total		\$

55 During the current tax year, did you receive more than \$15,102 that you treated as gifts from a foreign corporation or a foreign partnership? See instructions regarding related donors Yes No

If "Yes," complete columns (a) through (g) with respect to each such gift. If more space is needed, attach a statement.

(a) Date of gift	(b) Name of foreign donor	(c) Address of foreign donor	(d) Identification number, if any

This is an opportunity to cross reference and inquire as to any potential "covered gifts" or "covered bequests" in IRS Form 3520 (Part IV). The following questions could be posed:

- Was the foreign gift made by a person who used to be a U.S. citizen or a lawful permanent resident?
 Yes No
- Was the foreign bequest made by a person who used to be a U.S. citizen or a lawful permanent resident?
 Yes No

Importantly, the reporting requirements reflected on IRS Form 3520 (Part IV) for gifts, are only triggered if a certain threshold is satisfied. Section 2801 has no threshold, beyond the annual gift exclusion amount. Accordingly, question 54 of IRS Form 3520 (Part IV) for gifts and bequests could include an additional question i.e., a two part question: regarding gifts and bequests greater than the annual exclusion amount, currently US\$14,000.

³⁴ See, Section 6038D.
³⁵ See, Treasury Regulations section 1.6038D-5T Valuation guidelines.
³⁶ See, *Welch v. Helvering*, 290 US 111, 115 (1933) and *Rockwell v. Comm'r*, 512 F.2d 882 (9th Cir. 1975).

4. What concepts should IRS Form 708 include to report such gifts or bequests?

There are some additional basic concepts that must be identified and included on IRS Form 708 (and in the instructions), so taxpayers can accurately calculate the tax owing. For instance, in order to determine the amount of the tax pursuant to the statute, there should be a line item for each of the following:

- When was the covered gift or bequest received?
- What was the value of the covered gift or bequest received?
- What was the covered gift or bequest received?
- Who made the gift or bequest (and identify by name, relation and address)?
- Total value of covered bequests.

Curiously, these above items solicit the same basic information requested in Part IV of IRS Form 3520.

- The annual exclusion amount of any particular year, which is indexed for inflation (currently US\$14,000)³⁷
- Specific qualifying transfers to a charity.³⁸
- The marital deduction amount for inheritances received by a United States citizen spouse.³⁹
- The specific gift transfers received by a United States citizen spouse.⁴⁰
- specific transfers to a charity.⁴¹
- The amount of any gift or estate tax paid to a foreign country with respect to the covered gift or bequest.⁴²

Although not necessarily required to calculate the tax (specifically because the definition of “covered gift” or “covered bequest” excludes these items), additional line items should be included on IRS Form 708 that identifies the following property:

- Any property subject to gift tax that is shown on a timely filed gift tax return, IRS Form 709.⁴³
- Any property subject to estate tax that is shown on a timely filed estate tax return, IRS Form 706 or 706NA.⁴⁴

Each of these items should be reflected on the form 708.

5. Can the Tax under Section 2801 be Levied on the U.S. Citizen or Resident for Direct or Indirect Distributions made from a Foreign Trust?

Lastly, a most peculiar concept in Section 2801, is the language and concepts in Section 2801(e)(4)(B)(i) and (iii), regarding foreign trusts.

³⁷ See, Section 2801(c) referencing the annual gift exclusion amount in Section 2503(b).

³⁸ See, Section 2801(e)(3) referencing amounts which are allowed a deduction under Sections 2055 and 2522.

³⁹ *Id.* Section 2801(e)(3) referencing amounts which are allowed a deduction under Section 2056.

⁴⁰ *Id.* Section 2801(e)(3) referencing amounts which are allowed a deduction under Section 2523.

⁴¹ See, Section 2801(e)(3) referencing amounts which are allowed a deduction under Sections 2055, 2056, 2522 or 2523.

⁴²

⁴³ See, Section 2801(e)(2)(A).

⁴⁴ See, Section 2801(e)(2)(B).

Section 2801(e)(4)(A) imposes the tax on a domestic trust that receives a covered gift or bequest; not the beneficiaries.

In contrast, it is the U.S. beneficiary who pays the tax under Section 2801(e)(4)(B)(i) regarding transfers to a foreign trust (and eventually to the U.S. beneficiary). The tax is paid when the distribution is made from the foreign trust to the U.S. beneficiary and hence it is not the foreign trust that pays the tax in these circumstances.

These concepts are then turned on their head, due to the plain language of Section 2801(e)(4)(B)(iii), which allows a foreign trust to make an election to be treated as a domestic trust for purposes of the tax on covered gifts and bequests. This raises an important issue of how will the tax be collected when the election is made by the foreign trust? By statute, the foreign trust is now treated as a domestic trust in these circumstances and therefore is liable for payment of the tax (not the U.S. beneficiary). Of course, it is much easier for the IRS to collect the tax owing by a domestic trust with a U.S. trustee as opposed to a foreign trust with a foreign trustee.

However, a foreign trustee is generally not subject to the direct jurisdiction of Title 26. How then can the tax effectively be collected in these circumstances when the foreign trustee is not subject to the jurisdiction of the U.S. federal government? There appears to be no legislative authority to obligate or otherwise impose jurisdiction (directly or indirectly) against the foreign trustee if records are not provided regarding distributions from the trust?

This issue of how to collect the tax in these circumstances seems to be compounded by the limitations of estate and gift tax liens under Section 6324. Section 6324 extends only to taxes owed under Chapter 11 and 12 (estate and gift taxes) and not Chapter 15 (taxes on covered gifts and bequests).

In addition, there is a separate income tax provision regarding distributions from a foreign trust that grants the Secretary the authority to obligate a person to provide adequate records to the IRS (including the U.S. beneficiary). It would seem Congress would have imposed a similar concept under Section 2801 if it was their intention to grant such authority to the Secretary? Can the Secretary impose a regulatory rule that presumes all distributions from a foreign trust (which was funded in part by a covered expatriate) are a covered gift or bequest subject to the full tax? Would such a rule go beyond the legislative authority of the statute?

III. CONCLUSION

The lack of guidance (and no IRS Form 708) hinders the ability to ever collect the tax imposed under Section 2801. The recommendations in this proposal provide a common sense approach for guidance, presumably which needs to be issued in the form of regulations, to implement the timing of the payment of the tax (and its collection) on covered gifts and bequests. This law has been around since 2008 without the issuance of guidance.

IRS Form 3520 can be updated with some additional questions that will cross reference key facts that would enable taxpayers to even understand when such tax may be applicable. Estimates of value would be permitted, along the lines of other regulatory guidance along with additional concepts set forth in the statute.

Finally, the statute does not seem to allow the Secretary to obtain jurisdiction (directly or indirectly) over a foreign trustee who makes an election for the foreign trust to be taxed as a domestic trust for purposes of covered gifts and bequests.

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