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Breaking Developments in Tax Law

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Gifts and Bequests from Expatriates May Result in Tax Liability for U.S. Citizens and Residents

On June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008 (“HEART”) was signed into law. HEART generally extends various tax relief measures to members and veterans of the U.S. armed forces. However, HEART also takes a significant departure from the long-established U.S. gift and estate tax system, and now subjects the recipients of gifts and bequests from certain expatriates to significant tax liability.

Under the general U.S. gift and estate tax regime imposed under the Internal Revenue Code of 1986 (the “Code”), the transferor rather than the recipient of gifts and bequests is generally liable for U.S. federal estate and gift taxes. However, HEART amends this treatment by adding a new Chapter 15 to the Code entitled “Gifts and Bequests from Expatriates.” Section 2801 of Chapter 15 imposes tax liability on U.S. citizens and residents in receipt of gifts or bequests from “Covered Expatriates.” Covered Expatriates include U.S. citizens and long-term residents who, at the time of terminating their U.S. citizenship or residency:

- Have annual average net income tax greater than \$124,000 for the past 5 years;
- Have a net worth in excess of \$2,000,000; or
- Fail to certify under penalties of perjury that all obligations imposed under the Code have been satisfied for the past 5 years.

Section 2801 subjects the direct or indirect recipient of 1) any gift in excess of the annual gift exclusion defined in Section 2503(b) (\$12,000 as of 2008); or 2) any property by reason of a Covered Expatriate’s death, to tax at the highest rate of U.S. estate or gift tax in effect on the date such property is received, whichever is higher (49 percent as of 2008). The tax imposed by Section 2801 is reduced by the amount of any foreign gift or estate tax paid on the transfer. Moreover, transfers otherwise subject to U.S. estate or gift tax, as well as transfers to the transferor’s spouse or to charity, are generally exempt from tax under Section 2801 altogether.

Section 2801 also addresses transfers made by a Covered Expatriate into a foreign or domestic trust. Where a covered transfer is made to a domestic trust, the trust itself is treated as a U.S. citizen for purposes of Section 2801 tax liability. However, any U.S. beneficiary receiving a distribution from a foreign trust that has not made a valid election to be treated as a domestic trust will be subject to Section 2801 as though the distribution were an outright gift or bequest

from the Covered Expatriate. In that case, the recipient will be entitled to a deduction for the tax imposed under Section 2801 to the extent that the distribution is includable in gross income.

The application of Section 2801 is neither limited by time nor to assets which a Covered Expatriate owned on the date of expatriation. As a result, the recipient of gifts and bequests from a Covered Expatriate, regardless of the transfer date or whether the assets were acquired prior to or after expatriation, may be subject to the Section 2801 tax liability.

Summary

Section 2801 imposes a potentially burdensome and unexpected tax liability on U.S. persons receiving gifts and bequests from former U.S. citizens and residents. Section 2801 effectively taxes transfers made by former U.S. persons that would otherwise avoid U.S. taxation in most cases. By imposing the Section 2801 tax on the recipients of such transfers at the highest rate of tax in effect under the U.S. estate or gift tax rates tables, Section 2801 may ultimately force the recipient to dispose of any property received in order to satisfy this tax liability.

For more information, please contact the Tax Law Practice Group at Lane Powell:

206.223.7000 Seattle
503.778.2100 Portland
taxlaw@lanepowell.com
www.lanepowell.com

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