PLANNING FOR EXPATRIATES

Estate Planning for Expatriates Under Chapter 15

Section 2801 imposes special transfer tax rules on covered expatriates, but planning strategies may be implemented to reduce the provision’s impact.

Author: JOSEPH P. TOCE, JR. AND JOSEPH R. KLUEMPER

JOSEPH P. TOCE, JR., CPA, J.D., is the Office Managing Director of WTAS LLC’s New York Office and can be reached at joe.toce@wtas.com. JOSEPH R. KLUEMPER, J.D., is a Managing Director in the New York Office of WTAS LLC and can be reached at joseph.r.kluemper@wtas.com. The authors wish to express their thanks to Ross Nager, who is a Managing Director in the Houston Office of WTAS LLC, for his review and comment on this article. The views expressed herein are those of the authors alone.

In order to address concerns about individuals relinquishing U.S. citizenship or terminating long-term residency to avoid U.S. income, estate, and gift taxes, Congress has enacted various waves of expatriation tax regimes with the latest included in the Heroes Earnings Assistance and Relief Act of 2008 (“the HEART Act”). This article discusses Subtitle B, Chapter 15 of Title 26 of the U.S. Code, which was created under the HEART Act to supplement the U.S. estate and gift tax regimes for certain gifts and bequests received from covered expatriates. The analysis below assists practitioners in understanding the changes imposed by Chapter 15, as well as identify tax traps and planning opportunities.

Key tax distinctions

Under Chapter 12, U.S. citizens and residents are generally subject to U.S. gift tax on lifetime transfers of any property, wherever situated. Similarly, under Chapter 11, the estates of U.S. citizens and residents are generally subject to U.S. estate tax on all property located worldwide. On the other hand, nonresident aliens are generally subject to U.S. gift tax on transfers of only real property or tangible property located in the U.S. and U.S. estate tax on the transfer of U.S. situs property, including stock in a U.S. corporation. As such, with proper structuring, a nonresident who is not a U.S. citizen could greatly minimize or avoid U.S. gift and estate tax on gratuitous transfers to either U.S. persons or non-U.S. persons.

For gift and estate tax purposes, a resident is an individual who has his or her domicile in the U.S., and a nonresident is an individual who is not a resident. Absent a separate expatriation tax regime, an individual could relinquish his or her U.S. citizenship or terminate his or her long-term residency and become a nonresident alien in order to save substantial U.S. gift and estate taxes on future property transfers. Congress intended the expatriation regime imposed by Chapter 15 to make an individual’s decision to relinquish U.S. citizenship or terminate his or her long-term residency more tax-neutral; however, as discussed below, various tax planning opportunities remain.

Chapter 15 consists of only one section, Section 2801, which imposes a tax on U.S. citizens or residents who receive certain gifts and bequests on or after 6/17/2008, from certain expatriates. Although the IRS announced on 7/20/2009 that it plans to issue guidance under Section 2801, at the time of this writing little guidance has been issued, leaving practitioners to rely largely on the language of the statute. The Section 2801 tax is imposed on a calendar-year basis, and a new Form 708 will be issued by the IRS.
for purposes of reporting the receipt of such gifts and bequests. The IRS announced that the reporting and tax obligations for covered gifts or bequests received will be deferred, pending the issuance of guidance. As of the writing of this article, Form 708 has not been released.

**Factors in the expatriation decision**

This article explores selected estate and gift planning techniques for expatriates who are covered by Section 2801. Traditionally, expatriation has been inherently tax driven—a person currently taxed as a U.S. citizen or resident evaluates the tax advantages/disadvantages of exiting the U.S. tax regime. Absent tax advantages, there is seldom a reason to relinquish citizenship; however, privacy is becoming much more of a reason in light of a major enforcement by the IRS of foreign reporting requirements and the potential penalties that could be levied as a result of failure to file tax information forms. Nevertheless, the decision as to whether to expatriate is usually focused on the income, estate, and gift tax implications following expatriation.

In recent years, the U.S. income tax rates have been very favorable to U.S. citizens and residents who have substantial portfolio income with a 15% federal income tax rate on qualified dividends and long-term gains, as well as no federal income tax on municipal bond income. This is particularly the case where the individual lives in or migrates to a state where there is no income tax (e.g., Florida and Nevada) and as such pays only federal tax on portfolio income.

Avoiding these taxes, however, is generally not a sufficient impetus to leave the U.S. U.S. citizens and residents with large amounts of ordinary income such as wages, self-employment earnings, rent, etc. generally are not attracted to the concept of expatriation because, if the income is derived from the U.S., even as a nonresident, they would likely have to pay U.S. income tax on the earnings. Because individuals with significant portfolio income generally also have a substantial asset base, income tax planning as well as estate and gift tax planning must be viewed together when evaluating whether to expatriate.

The prospect of almost certainly higher tax rates on all types of income, as well as the 3.8% Medicare contribution tax imposed after 2012 on the net investment income and the continued high tax rates on gifts and estates, is causing many individuals to take a fresh look at the consequences of the new tax rules on expatriation. Another factor to consider is the depressed nature of most assets. One of the more dramatic changes to the income tax rules that affect expatriation is the “mark-to-market” regime whereby the expatriate is deemed to have sold all of his or her worldwide assets the day before expatriation. With asset values low, the mark-to-market gain will likely be smaller (or a loss). Also, to the extent gains exist, the exit tax under Section 877A will be calculated using current-law tax rates (especially the lower rate on long-term gains).

This article covers selected estate and gift tax observations and planning techniques under Chapter 15. As various other works have compared the new expatriation regime with the former regimes and outlined the technical qualifications under the statute, this article does not delve in any depth into the technicalities of who is a “covered expatriate” under new Section 877A and Section 2801, but assumes that an individual would be a covered expatriate should he or she relinquish U.S. citizenship or no longer be a long-time permanent resident (green card holder).

**Covered Expatriate Defined**

In general, under Section 877(a)(2), a covered expatriate includes an individual who meets any of the following tests:

1. The individual’s average annual net income tax for the five tax years ending before the date U.S. citizenship is lost is greater than an inflation-adjusted amount ($155,000 in calendar year 2013).
2. The net worth of the individual as of the date U.S. citizenship or long-term residency is lost is $2 million or more.
3. The individual fails to certify under penalty of perjury that he or she has met the requirements of the U.S. Tax Code for the five preceding tax years or fails to submit evidence of compliance imposed by the IRS.

Additionally, under Section 877(e), a long-term resident who ceases to be a lawful permanent resident (e.g., green card holder) is treated as a U.S. citizen who lost U.S. citizenship on the date of the cessation for purposes of Section 2801. Generally, a long-term resident means any individual (other than a U.S. citizen) who is a lawful permanent resident of the U.S. in at least eight tax years during the 15 tax years ending with the tax year during which the expatriation event occurs.

**Chapter 15 tax imposed on the recipient**
Unlike Chapters 11 and 12, which provide for a graduated-rate transfer tax system levied on the transferor based on the value of the property transferred, Chapter 15 imposes a tax at the highest marginal gift or estate tax rate on covered gifts and bequests received by a U.S. citizen or resident from a "covered expatriate." The tax imposed under Chapter 15 is reduced by gift or estate tax paid to a foreign country on such transfer.

The tax is paid by the recipient, not the transferor of the property. This is a departure from the general rule that a transferee pays no federal tax on gifts or bequests received.

**Lifelong reach of Chapter 15**

Unlike the income tax imposed on covered expatriates under Section 877A, which depending on the assets owned, is generally determined based on the fair market value of the property owned on the day prior to expatriation, the transfer tax regime imposed under Chapter 15 is perpetual. For income tax purposes, a covered expatriate generally continues to be subject to U.S. tax only on certain U.S.-source income and may need to watch the number of days in the U.S. to avoid residency. Subject to some exceptions, however, there are limited future U.S. income tax implications.

The Chapter 15 tax consequences for a covered expatriate are just beginning on the date of expatriation, and they do not end until death—or longer if property is bequeathed to a foreign trust. Section 2801 has no "mark-to-market" concept that would limit the transfer tax imposed on U.S. persons receiving a gift or inheritance from a covered expatriate. A covered expatriate, who is moderately wealthy when he expatriates, but then becomes extremely wealthy thereafter, faces the potential of Section 2801 imposing a tax on all of his or her wealth, even wealth generated after expatriation. The Section 2801 tax may be imposed even if the property transferred to a U.S. beneficiary was not owned by the covered expatriate at the time of expatriation.

**Example.** Edith Entrepreneur becomes a covered expatriate at age 30 when her net worth is $10 million. If Edith starts several extremely successful foreign corporations, growing her net worth to $250 million, then the entire $250 million would be subject to the Section 2801 tax regime. Even if Edith’s assets are not considered U.S. situs property and thus not subject to U.S. estate tax under Chapter 12, the tax imposed under Chapter 15 may be applied to all of her property passing to U.S. persons by gift or inheritance.

**Example.** The facts are the same as in the previous example, except that the bulk of Edith’s $250 million of wealth was inherited (after she expatriated) from her parents who have never been in the U.S. and are foreign nationals. The result is the same, and the Chapter 15 tax will be applied to all of her property passing to U.S. persons.

**Inclusive vs. exclusive**

The gift tax under Chapter 12 is tax exclusive if the donor survives the gift by three years. In contrast, under Chapter 15, the transfer is tax inclusive in the same manner that the estate tax generally is under Chapter 11. With a gift subject to Chapter 12, the donor pays the tax on the amount the donee receives, whereas with a transfer subject to Chapter 15 the recipient pays tax on the entire amount received.

**Example.** Donald Donor, a U.S citizen who has already used up his lifetime exemption amount, makes a gift under Chapter 12 of $1 million of Argentine real estate to Sally, a U.S. person. Assuming the federal gift tax rate is 35%, the tax owed by Donald is $350,000, which is reported on his Form 709 gift tax return. In order for Sally to receive a net gift of $1 million, Donald would be out of pocket $1.35 million.

**Example.** The facts are the same as the previous example, except that Donald Donor is a covered expatriate. If the gift is subject to Chapter 15, Sally would owe $350,000 of tax and would have a net gift after taxes of $650,000 instead of the $1 million in the previous example. Sally would be responsible for filing the Form 708. In order for Sally to have a net gift of $1 million from property subject to Chapter 15, Donald would have to make a gift of $1,538,462 to provide Sally with enough to pay the $538,462 of tax due.

**Covered gift or bequest**

The tax imposed under Chapter 15 applies to “covered” gifts or bequests. A covered gift is generally any property acquired by gift directly or indirectly from a covered expatriate. An important exception, however, provides that a transfer otherwise subject to U.S.
gift tax and properly shown on a timely filed return of tax imposed by Chapter 12 is not considered a covered gift. 27

Under Chapter 12, U.S. gift tax is generally imposed on nonresident aliens only on transfers of real property or tangible property located in the U.S. 28 As such, a transfer is not a covered gift if it is of real property or tangible property located in the U.S and the covered expatriate reports it correctly on a timely filed Form 709. Arranging transfers to U.S. persons to intentionally be subject to tax under Chapter 12 can provide a valuable gifting strategy to avoid the tax inclusive issue described above.

Example. The facts are the same as in the previous example, except that the $1 million of real estate that Donald Donor gifts is located in New York. Because this transfer is subject to the tax imposed under Chapter 12, with a federal gift tax rate of 35%, the federal tax owed by Donald is $350,000. This is reported on his Form 709. Although Donald is a covered expatriate, the transfer is not considered a covered gift to Sally, and she would have no tax liability from the receipt of the gift.

A covered bequest generally is any property acquired by reason of the death of a covered expatriate. 29 There is also an exception providing that any property included in the gross estate of the covered expatriate for purposes of Chapter 11 and shown on a timely filed return of tax imposed by Chapter 11 (Form 706) is not a covered bequest. 30 Generally, under Chapter 11, the U.S. estate tax is imposed on the transfer of U.S. situs property. 31 As such, bequests of U.S. situs property properly reported on a Form 706 estate tax return are not considered a covered bequest. This causes the estate tax to be non-inclusive as the foreign estate will pay the U.S. tax only on the U.S. situs property and not on the funds used to pay the tax.

State tax

Also noteworthy is that as of the writing of this article, no state imposes an additional tax on covered gifts or bequests received from a covered expatriate. As such there may be state tax savings for individuals who break domicile from a state that imposes a gift or estate tax. Additionally, if the covered expatriate bequeaths U.S. situs property, such as stock in U.S. corporations, there may be no state inheritance tax, and the U.S. estate tax should be non-inclusive.

Annual exclusion

Section 2801(c) provides that a U.S. person is subject to tax under Section 2801(a) only to the extent the value of covered gifts and bequests received exceed the annual exclusion amount as defined in Section 2503(b), which is $14,000 for 2013. Unlike the annual exclusion for gift tax purposes under Chapter 12, which allows an unlimited number of donors to transfer the annual exclusion amount to a single donee gift tax free, the exception for a donee for Chapter 15 is limited to only $14,000 each year for covered gifts and bequests received from all covered expatriates.

Example. Charles, a U.S. citizen, receives covered gifts valued at $14,000 from each of his parents, who are both covered expatriates. Charles is subject to tax on $14,000 of the covered gifts received. (If Charles parents were not covered expatriates, the full $28,000 of gifts would likely not have been subject to gift tax due to the gift tax annual exclusion.)

It appears that a covered expatriate could take advantage of the Section 2503(b) annual exclusions under Chapter 12. As discussed above, any property reported on a timely filed return of tax imposed under Chapter 12 is not considered a covered gift. 32 Therefore, a covered expatriate should be able to gift to a single U.S. donee $14,000 of real property or tangible property located in the U.S., as well as $14,000 of non-U.S. situs assets without tax being imposed on the covered expatriate or the donee.

Example. The facts are the same as in the previous example, except that Charles receives $14,000 of tangible property located in the U.S. from each of his parents. Additionally, Charles’ father gifted $14,000 of non-U.S. situs property. The transfer of the tangible property should not be a covered gift because it is subject to the tax imposed under Chapter 12. Charles’ parents would owe no gift tax, however, because the gifts are within their gift tax annual exclusion amounts. Additionally, although non-U.S. situs assets are generally considered covered gifts, Charles would not owe tax on the receipt of the non-U.S. situs property because its value is within the exception amount of Section 2801(c).

In the previous example, only $14,000 was able to be gifted without the imposition of a tax. With planning, however, Charles was able to receive $42,000 without the transfer being subject to tax.

Although the annual exclusion for general gift tax purposes of Chapter 12 is available for gifts of only present interests in property 33 (e.g., outright gifts of cash, securities, or tangible property), the present interest requirement does not appear to be imposed on
transfers made by covered expatriates to domestic trusts. Under Section 2801(e)(4)(i), which is discussed further below, a domestic trust is treated as a U.S. citizen for purposes of Chapter 15. As such, a transfer by a covered expatriate to a domestic trust, which would generally be considered a transfer of a future interest for purposes of Chapter 12, should be subject to tax under Section 2801 (a) only to the extent the value of covered gifts and bequests received by the trust exceeds the annual exclusion amount of $14,000.

It is unclear whether Crummey withdrawal powers, which are often granted to multiple beneficiaries of a trust to satisfy the present interest requirement of Chapter 12, would allow for more than one Section 2801(c) exclusion. Another question is whether transfers to several trusts with similar but perhaps not identical beneficiaries would permit the exclusion of $14,000 of gifts annually to all such trusts.

Marital and charitable transfers

Chapter 15 generally provides that a transfer is not a covered gift or bequest to the extent it would qualify for a marital or charitable deduction under Chapter 11 or 12 if the covered expatriate was a U.S. person. Generally, an unlimited marital deduction is allowed for gifts and bequests made by a U.S. person to a spouse who is a U.S. citizen. Similarly, when a covered expatriate transfers property to a U.S. spouse, Congress decided that an exception should be allowed. This provision effectively defers the imposition of a transfer tax until the spouse subsequently transfers the property. As a U.S. citizen, the spouse would be subject to U.S. gift or estate tax on future transfers. This marital exception generally does not apply to transfers to a non-U.S. citizen spouse; however, a transfer may qualify for the exception if it is to a “qualified domestic trust” for the benefit of a surviving non-U.S. citizen spouse.

Educational and medical expenses

One popular gift tax break for transfers under Chapter 12, but not expressly provided for under Chapter 15, is the exclusion for certain educational and medical expenses. Under Section 2503(e), transfers made on behalf of individuals to a qualified educational organization for tuition are not considered a gift for purposes of Chapter 12 and, therefore, are not subject to gift tax. Likewise, transfers made on behalf of individuals directly to qualified medical care providers are not considered a gift.

Unfortunately, Congress did not include such exceptions in Chapter 15. As such, any educational or medical expenses paid by a covered expatriate on the behalf of a U.S. person may be considered an indirect gift, and the U.S. person might be subject to the tax under Section 2801. An individual planning to expatriate may be able to pre-pay tuition for children, grandchildren, and others, which if properly structured prior to expatriation may qualify for exclusion from gift tax.

Transfers to trusts

Special rules apply to gifts or bequests from covered expatriates to trusts. A domestic trust is treated as a U.S. citizen and is subject to the Section 2801 tax in the year the transfer is received. The tax consequences of transfers to a foreign trust are deferred until the foreign trust actually makes a distribution to a U.S. citizen or resident. To the extent a distribution from a foreign trust is included in a beneficiary’s gross income, the beneficiary is allowed an income tax deduction for the Section 2801 taxes paid. Alternatively, a foreign trust may make an election, solely for purposes of Section 2801, to be treated as a domestic trust. Thus, planning opportunities exist either to pay tax currently, or to defer tax on gifts and bequests through the choice of a domestic or a foreign trust.

Noncitizen/non-green card holder is never a covered expatriate

An important pre-immigration strategy for an individual who is not a U.S. citizen is to consider avoiding becoming a covered expatriate. Only gifts or bequests from covered expatriates are subject to the Chapter 15 tax. By simply avoiding becoming a green card holder, an alien will never be a long-term resident who ceases to be a lawful permanent resident, and as such will never be a covered expatriate. Foreign nationals working in the U.S. should investigate with experienced immigration counsel alternatives to a green card that may meet work and personal commitments. Someone who is not a U.S. citizen and does not have a green card cannot be considered a covered expatriate, even if he or she is a former U.S. resident for income tax purposes, such as under the substantial presence test. Alternatively, an individual who already has a green card could relinquish it prior to being considered a lawful permanent resident of the U.S. in at least eight tax years during the period of 15 tax years ending with the tax year to avoid being considered a covered expatriate.
Example. Francine Smith is a foreign national who had been living in the U.S. for years, but never obtained a green card. Francine decides to return to her home country, which she establishes as her new domicile. Francine then makes gifts of $20 million of intangible property to family members who are U.S. persons. Because Francine is not a U.S. citizen and never had a green card, she is not a covered expatriate and is not subject to tax under Chapter 15. Also, as a nonresident alien, because the gifts are not of real property or tangible property located in the U.S., the transfer is not subject to gift tax under Chapter 12.

Example. The facts are the same as in the previous example, except that Francine bequeathed the $20 million of intangible property at death. As above, because Francine is not a covered expatriate, the transfer would not be subject to tax under Chapter 15. Additionally, as a nonresident alien, because the transfer was not of U.S. situs property, it would not be subject to tax under Chapter 11.

Generation-skipping transfer planning

Although Chapter 15 is designed to generally capture transfers received from covered expatriates that would otherwise be subject to the U.S. gift and estate tax regimes of Chapter 11 and 12, it does not provide for an additional tax on a generation-skipping transfer (GST), such as the tax levied under Chapter 13. The GST tax is generally imposed on gifts or bequests to beneficiaries more than one generation below that of the transferor, and includes direct transfers to persons as well as those involving trusts having beneficiaries more than one generation below that of the transferor.

Prior to the passage of the GST tax, wealthy individuals could transfer wealth to long-term trusts for the benefit of descendants in order to avoid repeated exposure to U.S. gift and estate taxes. By bypassing generations, wealthy families were able to keep assets out of the taxable estates of the intermediate generations. Congress designed the GST tax in order to impose an additional tax at a flat tax rate equal to the highest U.S. estate tax rate on transfers otherwise designed to skip generations.

Transfers by nonresident, noncitizens of the U.S. are generally subject to the Chapter 13 GST tax on direct skip transfers only to the extent that the transfer is subject to U.S. gift or estate tax. Also, a taxable distribution or termination from a trust is subject to the Chapter 13 GST tax only to the extent that the initial transfer of property to the trust was subject to U.S. gift or estate tax. As such, if a covered expatriate makes a transfer to a U.S. person that is not subject to U.S. gift or estate tax, then the GST tax should not apply. The ability to bypass generations without being subjected to the GST tax can be a valuable planning strategy for covered expatriates, particularly for wealthy individuals who are elderly or terminally ill.

Example. Raymond Kim, age 85, is terminally ill. Each of his three children is already very wealthy. He wants to bequeath his entire remaining estate of $54 million to his grandson, who is a U.S. person. Raymond is a U.S. citizen, who has used all of his lifetime gift and GST exemption amounts. Assuming that at Raymond's death the combined state and federal estate tax rate is 50% and the GST tax rate is 35%, the total taxes on the transfer would be $34 million, leaving only $20 million after tax for his grandson.

Example. The facts are the same as in the previous example, except that Raymond becomes a covered expatriate and is not considered domiciled in the U.S. at the time of his death. The receipt of the $54 million inheritance would be subject to Chapter 15, and assuming a 35% tax rate, the grandson would owe $18.9 million of tax. The grandson would have a net bequest, after taxes, of $35.1 million, which is over $15 million more than in the previous example. Because the transfer would not be subject to U.S. estate tax, the GST tax would not apply.

Transfers to non-U.S. persons

Chapter 15 imposes a tax on gifts or bequests from covered expatriates that are made only to U.S. citizens or residents. As discussed above, nonresident aliens are generally subject to U.S. gift tax on transfers of only real property or tangible property located in the U.S. and U.S. estate tax on the transfer of U.S. situs property. If a wealthy individual does not intend to make gifts or leave inheritances to U.S. persons, then expatriating can result in substantial transfer tax savings.

Example. Jacques, who is a long-time green card holder, recently sold his company for $200 million. None of Jacques' beneficiaries are U.S. citizens or residents. Assuming he has no meaningful appreciation in his assets, Jacques would not face an income tax under Section 877A on expatriation. If Jacques expatriates and subsequently bequeaths $200 million of non-U.S. situs property to his heirs, no U.S. transfer tax would be imposed. Assuming a 35% tax rate, the estate tax savings would be nearly $70 million.
Also, Chapter 15 does not apply to transfers from covered expatriates to covered expatriates who are not U.S. residents, which can provide an excellent planning opportunity.

**Example.** The facts are the same as in the previous example, except that Jacques has three children who are U.S. persons at the time of his expatriation. Ten years later, when Jacques is worth $400 million, he becomes very ill. His U.S. children could themselves become covered expatriates. If Jacques dies and leaves all his property to his covered expatriate children, no tax would be imposed under Chapter 15 because they are no longer U.S. citizens or residents. Alternatively, prior to the expatriation of Jacques' children, he may fund a foreign trust to hold the assets for their benefit until they become covered expatriates also.

If a covered expatriate has beneficiaries that are U.S. citizens or residents, as well as beneficiaries that are non-U.S. persons, then estate planning can be done to minimize U.S. tax. For example, a covered expatriate could leave the portion of his or her estate that is of U.S. situs assets, which are subject to U.S. estate tax, to U.S. beneficiaries and leave the non-U.S. situs property to non-U.S. persons, which would not be subject to U.S. tax. This also allows for a tax-exclusive inheritance to the U.S. recipients.

**Planning prior to expatriation**

A U.S. person is able to make lifetime gifts (i.e., gifts above the annual exclusion) of up to the gift and estate tax exclusion amount ($1 million in 2013, decreased from $5.12 million in 2012, but subject to change by future legislation) without being subject to tax. As such, prior to expatriating, a person should consider using up his or her full lifetime gifting amount to transfer assets to U.S. persons, gift tax free. Once a person becomes a covered expatriate and is not a U.S. resident, the gift and estate tax exemption is no longer available. Using the lifetime gifting exclusion prior to expatriation for gifts to persons who are not U.S. citizens or residents is generally not effective planning because, as discussed above, after expatriation a covered expatriate can make unlimited gifts of non-U.S. property to individuals who are not U.S. citizens or residents.

**Tax basis considerations**

Generally, when a gift of appreciated property is made, a donee has a carryover income tax basis in the property, which is the same tax basis it had in the hands of the donor. However, if the transfer is subject to gift tax under Chapter 12, the donee’s basis is increased by all or part of the gift tax paid on the gift. The basis increase is the gift tax attributable to the “net appreciation” of the gift, which is determined by multiplying the gift tax paid by the net appreciation in value of the gift, divided by the gift.

The income tax provisions do not provide for such a basis increase for taxes paid by the donee under Chapter 15. As such, careful consideration is advisable in selecting assets being gifted to U.S. persons, including the income tax implications to both the covered expatriate and the donee when the property is disposed of. Often, the covered expatriate should make gifts of high-basis property, or sell low-basis property and gift the proceeds.

**Additional planning by covered expatriates**

Although many of the traditional estate planning techniques still work for a covered expatriate with U.S. beneficiaries, the interplay of Chapters 11 and 12 with Chapter 15 should be carefully considered. For example, a pre-expatriation grantor retained annuity trust (GRAT) should be effective in avoiding the imposition of Chapter 15 tax on the recipient at the end of a successful GRAT term even if the donor expatriates during the GRAT term. However, the tax treatment of post-expatriation transfers to GRATs raises interesting questions, and the assets used to fund the GRAT, as well as whether it is treated as a foreign or domestic trust may have various implications. This issue arises because Chapter 14 focuses on the valuation of the interest retained by the transferor, whereas the Chapter 15 regime imposes the tax based on the value received by the recipient.

A covered expatriate should be able to make loans to a U.S. person, as well as trusts or entities owned by U.S. persons, without triggering a Section 2801 tax as long as the loans bear an adequate interest rate. The use of foreign trusts by a covered expatriate may defer the Section 2801 tax, as well as provide for income tax savings opportunities; careful planning is required, however, to minimize the confiscatory accumulation distribution rules of Sections 665 through 668.

Also, avoiding or planning around covered expatriates in the “family tree” is an important part of the family’s overall estate planning. For example, if a grandfather is a nonresident alien, who is not domiciled in the U.S., instead of transferring property to a covered expatriate son, which could create future Chapter 15 issues, he could make the transfers to grandchildren who are not considered
covered expatriates. By bypassing the covered expatriate with the transfer of assets that are ultimately intended for grandchildren or future generations, the future Chapter 15 taxes that may be imposed on the covered expatriate are minimized.

**Conclusion**

There are many open questions under Chapter 15 that will likely be addressed through regulations and other guidance. In the interim, the following points are important:

- For non-U.S. citizens, carefully weigh the expatriation tax implications when deciding whether to obtain a green card.
- For current green card holders, consider whether relinquishing the green card before becoming a long-term resident may be beneficial.
- Prior to expatriating, consider using up the lifetime gift exemption amount ($1 million in 2013, decreased from $5.12 million in 2012, but subject to change by future legislation) with transfers to U.S. persons.
- Once an individual becomes a covered expatriate, arrange transfers to U.S. persons to be of real or tangible property subject to Chapter 12, to avoid the tax inclusiveness of Chapter 15.
- Annual exclusion gifts, foreign trusts, GRATs, and other estate planning techniques should be analyzed with special attention to the twists caused by the application of Chapter 15.
- The tax basis of assets transferred by a covered expatriate should be considered.
- The ability to skip generations without being subject to the GST tax may be a powerful tax planning strategy of a covered expatriate.

---

2. Section 877A, which was also included as part of the HEART Act to impose an income tax on certain expatriates, is not discussed in depth in this article. Section 877A has already covered been cover in many articles, such as Packman, “The Tax Rules Just Changed: Emotions Aside, Does Expatriating Make Financial Sense?,” 109 J. Tax’n 68 (August 2008).
3. The “Chapters” referred to in this article are from Subtitle B of the Internal Revenue Code.
4. This article focuses on Section 2801, which is a federal tax, and does not address state tax issues. To date, the authors are not aware of any states that have enacted legislation similar to Chapter 15. However, many states have inheritance taxes, some significant, that could affect the expatriation decision.
5. Section 2501; Reg. 25.2501-1.
7. Section 2501(a)(2); Reg. 25.2511-1(b).
8. Sections 2103 through 2105.
9. Unlike the determination of residency for income tax purposes under the objective tests under Section 7701(b), whether an individual is a resident for transfer tax purposes depends on the subjective determination of “domicile” at the time of the transfer. Under Regs. 20.0-1(b)(1) and 25.2501-1(b), an individual acquires a domicile in a place by living there, for even a brief period of time, with the intent to remain indefinitely.
10. General Explanations of Tax Legislation Enacted in the 110th Congress, Joint Committee on Taxation.
Sections 2107 and 2501(a)(3), which provided the transfer tax regime applicable to pre-6/17/2008 transfers, were effectively repealed by the HEART Act.


Section 2801(a).

Ann. 2009-57; 2009-29 IRB 158. The due date for filing Form 708 will be included in future IRS guidance, and the IRS has stated that it will provide a reasonable period after the issuance of the guidance for the filing of the return and the payment of the tax.

For certain individuals who expatriated prior to 6/17/2008, a separate estate and gift tax regime is imposed under Sections 2107 and 2501, which are not applicable to those who expatriate on or after 6/17/2008.

Section 1411.

Section 877A.

Sections 2001, 2501, and 2502.

Sections 2801(a)(1) and (b).

Section 2801(d).

Sections 2002 and 2502(c).

Section 877A generally imposes a "mark to market" tax on all property of a covered expatriate, which is treated as if it were sold on the day before the expatriation date for its fair market value.

After expatriation, for income tax purposes unless the covered expatriate is considered a resident alien, he is treated as a nonresident alien and as such is generally only subject to U.S. income tax on certain income effectively connected with a U.S. business or investment type income from U.S. sources. Section 871.
Section 2503(b)(1).

Section 2801(e)(3).

Sections 2056(d)(2) and 2056A.

Section 2801(e)(1)(a).

Ltr. Rul. 200602002; TAM 199941013.

Section 2801(e)(4)(A).

Section 2801(e)(4)(B)(i).

Section 2801(e)(4)(B)(ii).

Section 2801(e)(4)(B)(iii). As of the writing of this article, guidance has not been issued on the procedures for a foreign trust to elect to be treated as a domestic trust.

Section 7701(b)(6)(A).

Section 877(e)(2).

Section 2501(a)(2); Reg. 25.2511-1(b).

Sections 2103 through 2105.

Section 2601.

Section 2612.

Section 2602.


Based on the assumptions, the combined state and federal estate tax from the testamentary direct skip would be $27 million, and the GST tax would be $7 million.

Section 2801(a).

Section 2501(a)(2); Reg. 25.2511-1(b).

Sections 2103 through 2105.

Section 2505.

Section 1015(a).
Although Section 2801(e) provides the general rule that property acquired by gift from a person who is a covered expatriate at the time of the acquisition is a taxable transfer under Chapter 15, there is an exception to the general rule provided by Section 2801(e)(2) that excludes taxable gifts reflected on a gift tax return from the Chapter 15 tax.

If real property or tangible property located in the U.S. is transferred into a domestic trust, the transfer should be subject to Chapter 12, and Chapter 14 should provide the methodology to value the remainder for gift tax purposes. It is unclear as to how a remainder would be valued for transfers of intangibles to a domestic trust as Chapter 15 focuses on the value received by the trust, and the transfer is treated as if it were to a U.S. citizen under Section 2801(e)(4)(A). A GRAT that is a foreign trust would probably not be an effective technique, although an election may be made to be treat it as a domestic trust under Section 2801(e)(4)(B)(iii).