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CC:PA:LPD:PR (REG-112997-10)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC

Re: Comments to Proposed Regulations (IRS-REG-112997-10) Guidance under Section 2801 Regarding the Imposition of Tax on Certain Gifts and Bequests from Covered Expatriates

Dear Sir or Madam:

The New York City Bar Association, through the Estate and Gift Tax Committee, respectfully submits its comments on the Proposed Regulations (IRS-REG-112997-10), Guidance under Section 2801 Regarding the Imposition of Tax on Certain Gifts and Bequests from Covered Expatriates (the "Proposed Regulations").

Numerous organizations and commentators have submitted comments to Treasury and the Internal Revenue Service (the "Service"). Accordingly, we limit our comments to the following areas:

- The determination of how contributions to or distributions from a non-electing foreign trust to a U.S. citizen spouse could qualify for the marital exception in Section 2801(e)(3)[1], a topic for which the Proposed Regulations specifically request comment;
- The determination of when a transfer qualifies for the exception for transfers subject to gift or estate tax;
- The determination of whether and how a recipient of a gift or bequest is able to determine responsibility for complying with Section 2801; and

[1] Unless otherwise indicated, "Section" references herein are to the Internal Revenue Code of 1986, as amended.

- The determination of when a transfer qualifies for the annual exclusion.

I. Qualification for the Marital Exception to 2801

The Treasury specifically requests comments on the following issue: "How contributions to or distributions from a non-electing foreign trust to a U.S. citizen spouse could qualify for the marital exception in Section 2801(e)(3), taking into account the rules applicable to domestic trusts and foreign trusts in Section 2801(e)(4)."[2]

A. Proposed Regulations

The Proposed Regulations address this issue. Specifically, Treasury interprets the marital deduction exception under Section 2801(e)(3) not to apply to distributions from a non-electing foreign trust to a U.S. citizen spouse. Instead, the Proposed Regulations appear to treat contributions to non-electing foreign trusts in the same manner as contributions to domestic trusts – the determination of whether the marital exception applies is made at the time of the covered expatriate's contribution to the trust.[3] The Preamble to the Proposed Regulations specifically states that "[t]o the extent a covered gift or covered bequest is made to a foreign trust (or to the separate share of the trust), a distribution from the trust (or from the separate share of the trust) to the U.S. citizen spouse of the covered expatriate who funded the trust (whether in whole or in part) will not qualify for the [marital] exception."[4] On the other hand, the Proposed Regulations acknowledge that a gift or bequest from a covered expatriate to his or her U.S. citizen spouse directly is exempt under the marital exception.[5]

We believe that the statutory language supports a different interpretation, which is more consistent with the purpose of tax neutrality.[6]

B. Analysis

Under Section 2801, a covered gift or bequest is generally a gift or bequest made by a covered expatriate to a U.S. citizen or resident.[7] In the context of non-electing foreign trusts, the tax is

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[2] Notice of Proposed Rulemaking and Notice of Public Hearing, Fed. Reg. Vol. 80, No. 175 (September 10, 2015) (hereinafter "Notice") at p. 54454.

[3] Prop. Treas. Reg. Section 28.2801-5(a).

[4] Notice at 54449-54450.

[5] Prop. Treas. Reg. Section 28.2801-3(c)(4).

[6] Notice at 54448 (Report of House Ways and Means Committee proposing the enactment of Section 2801 stated that "an individual's decision to relinquish citizenship or terminate long-term residency should not affect the total amount of taxes imposed (that is, it should be 'tax neutral')").

[7] Section 2801(e)(1).

imposed on a distribution from such foreign trust to a U.S. citizen or resident "in the same manner as if such distribution were a covered gift or bequest" and not upon contribution by a covered expatriate to a non-electing foreign trust.[8] One exception to "covered gifts or bequests" includes transfers which would qualify for the charitable or marital deductions if the donor or decedent were a U.S. person.[9] We believe that the determination of whether the marital exception applies, given the statutory construct, should be made at the time of the distribution from a non-electing foreign trust.

Since the Section 2801 tax is imposed at the time of a distribution from a non-electing foreign trust to a U.S. trust beneficiary, the applicability of the marital exception should be determined at the time of the taxable event (that is, when the tax is imposed upon distribution). This approach is consistent with the application of the marital deduction in the context of the estate and gift tax regime.[10] The determination of whether the marital deduction applies under the estate and gift tax is made at the time the potential transfer tax is imposed on the donor or estate.[11] The Proposed Regulations provide a similar rule with respect to domestic trusts (as the marital exception is considered upon a contribution to the trust, which is the taxable event).[12] In the case of a non-electing foreign trust, however, the taxable event occurs at the time of a distribution from the trust to the U.S. person and not on the contribution of property to the trust.[13] Therefore, it is appropriate to test whether the marital exception applies upon the occurrence of such distribution (and not upon contributions to the non-electing foreign trust).

1. Distributions to or for U.S. Citizen Spouses

In light of the foregoing, if the spouse is a U.S. citizen, an outright distribution from a non-electing foreign trust to such spouse should qualify for the marital exception and no tax should

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[8] Section 2801(e)(4)(B).

[9] Section 2801(e)(3).

[10] Notably, Section 2801 is designed to apply the transfer tax regime in a modified fashion to certain gifts and bequests by non-U.S. citizen donors and decedents to create a tax neutral result if a U.S. citizen expatriates (and, therefore, the marital deduction should be interpreted consistently under Section 2801).

[11] Whether the estate tax marital deduction applies is determined at the time the estate tax is imposed. *See* Section 2001(a); Section 2056. Likewise, whether the gift tax marital deduction applies is determined at the time the gift tax is imposed. *See* Section 2501(a)(1); Section 2523. In determining whether the marital deduction applies, the transferor must look at the facts at the time of the transfer to determine if the gift or bequest is of a terminable interest (subject to a prohibited contingency). *See* Section 2523(b); Section 2056(b); Estate Planning Explanations (RIA) 20,564.06 ("The date of death is the point of time from which to judge the nature of the surviving spouse's interest for purposes of terminability").

[12] Prop. Treas. Reg. 28-2801-3(d), -4(a)(2).

[13] For instance, upon a distribution, the distributee must then determine what portion of the trust was transferred by a covered expatriate. Prop. Treas. Reg. 28.2801-5(c)(i) ("Specifically, this portion of each distribution is determined by multiplying the distributed amount by the percentage of the trust that consists of its covered portion immediately prior to that distribution (section 2801 ratio).").

be imposed under Section 2801. Similarly, distributions from a non-electing foreign trust to a domestic trust meeting the marital deduction trust requirements should qualify for the marital exception.[14] This foregoing rule should apply regardless of whether the non-electing foreign trust itself was in the form qualifying for the marital deduction.[15]

2. Distributions to or for U.S. Resident (Noncitizen) Spouses

In regard to transfers to U.S. resident (noncitizen) spouses, Treasury interprets Section 2801 as providing that "gifts and bequests made by a covered expatriate to his or her noncitizen spouse are subject to an annual limit under section 2523(i)."[16] In addition, "a bequest from a covered expatriate to his or her noncitizen surviving spouse who is a U.S. resident is not a covered bequest to the extent the bequest is to a qualified domestic trust (QDOT) that satisfies the requirements of section 2056A and the corresponding regulations, and for which a valid QDOT election is made."[17] The Proposed Regulations do not specifically discuss the applicability of the marital exception to distributions from a non-electing foreign trust to or for a U.S. resident (noncitizen) spouse.

With respect to distributions from a non-electing foreign trust to or for a U.S resident (noncitizen) spouse, the determination of whether the expanded annual exclusion applies or whether a transfer was made to a qualified domestic trust (QDOT) should occur at the time the Section 2801 tax otherwise would be triggered: namely, at the time of the distribution from the non-electing foreign trust. Accordingly, if the covered expatriate with respect to a covered gift or bequest to a non-electing foreign trust is not living at the time of the distribution to or for a U.S. resident (noncitizen) spouse, such distribution will qualify for the marital exception only if it is made to a QDOT. If the covered expatriate is living at the time of the distribution, the expanded annual exclusion amount should apply under Section 2523(i), sheltering such amount of a distribution to a U.S. resident (noncitizen) spouse from the Section 2801 tax.

C. Marital Deduction Trust Elections

In the Preamble to the Notice and the Proposed Regulations, Treasury refers to the requirement that a covered expatriate make a qualifying QTIP or QDOT election so that the marital deduction may apply to a transfer in trust for a U.S. citizen or resident spouse. However, it is unclear, absent U.S. situs property, how a covered expatriate or his or her estate is to make such elections for direct transfers to a qualifying marital trust since neither Form 706 nor Form 706-NA is

[14] *See* Sections 2056(b)(5), 2056(b)(7), 2056(b)(8), 2523(e), and 2523(f).

[15] Under Section 2801(e)(4)(B), the non-electing foreign trust would be deemed the donor or decedent of a covered gift or bequest since distributions should be considered in the same manner as if they were covered gifts or bequests.

[16] Notice at 54450. Section 2523(i) provides that the unlimited marital deduction is not available for outright, lifetime gifts to a non-U.S. citizen spouse. However, an expanded annual exclusion amount is available for gifts to such spouse. Query why bequests should be subject to the gift tax limitation under Section 2523(i).

[17] *Id.*; Prop. Treas. Reg. Section 28.2801-3(c)(4).

required to be filed by an executor or other person. Guidance also should be provided concerning a QTIP or QDOT election with respect to a distribution from a non-electing foreign trust to an otherwise qualifying marital trust for a U.S. spouse (assuming the regulations adopt the approach described in the preceding section).

We recommend that, since the Section 2801 tax is imposed on the U.S. recipient and not on the covered expatriate or his or her estate, the U.S. recipient should make the QTIP or QDOT election at the time the tax is imposed (that is, at the time of a distribution from a non-electing foreign trust to a qualifying marital trust). Therefore, for purposes of the marital exception under Section 2801, we recommend that the U.S. recipient make the QTIP or QDOT election on Form 708. In addition, the regulations should confirm that the QDOT taxable distributions rules would apply to the Section 2801 tax in the same manner as the estate tax under Section 2001.

D. Tax Neutrality

Our interpretation of the marital exception under Section 2801 fosters tax neutrality. Under the Proposed Regulations, a tax would be imposed on a U.S. citizen spouse upon the receipt of a distribution from a non-electing foreign trust, but not with respect to direct payment to a U.S. citizen spouse from a covered expatriate (or U.S. person). Similarly, a tax would be imposed upon distributions from a non-electing foreign trust to a domestic trust for a U.S. citizen spouse qualifying for the marital deduction, yet a direct gift or bequest by a covered expatriate to such trust would not be subject to tax. In addition, for U.S. resident (noncitizen) spouses, distributions from a non-electing foreign trust to such spouses would not benefit from the expanded annual exclusion or the availability of a QDOT, while direct gifts or bequests from covered expatriates would benefit from such marital exceptions.

The tax result should not differ based on whether there is an intervening non-electing foreign trust.[18] Our proposed interpretation would treat gifts or bequests made by covered expatriates directly or indirectly (through non-electing foreign trusts) to or for U.S. spouses in the same manner.

[18] Section 2611(b), in the context of the generation-skipping transfer tax, offers an instructive analogy. Trustee payments made from trusts for a grandchild's education qualify for the tuition exception as if such payment were made by an individual rather than a trust.

II. Exception for Transfers Subject to Gift or Estate Tax

Section 2801(e)(2) excludes from the definition of a covered gift or bequest "[A] any property shown on a timely filed return of tax imposed by chapter 12 which is a taxable gift by the covered expatriate, and (B) 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 of the estate of the covered expatriate."[19] This exception applies to a covered expatriate who, through gift or bequest, makes a transfer of U.S. situs property, rendering said property outside the scope of Section 2801, provided said transfer is shown on a timely filed Form 709, Form 706, or Form 706-NA, as the case may be.

A. Proposed Regulations

The Proposed Regulations include a requirement – the timely payment of tax – which is not included in the statute. Specifically, with respect to taxable gifts, the Proposed Regulations provide as follows: "A transfer of property that is a taxable gift…and is reported on the donor's timely filed Form 709 is not a covered gift, *provided that the donor also timely pays the gift tax*…." (emphasis added).[20] The Proposed Regulations also require timely payment with respect to taxable bequests, stating: "Property that is included in the gross estate of the covered expatriate and is reported on a timely filed Form 706 or Form 706-NA is not a covered bequest, *provided that the estate also timely pays the estate tax*…." (emphasis added).[21] We believe that Treasury's interpretation is unsupported by the statutory language and is inconsistent with the objective of tax neutrality.[22]

B. Analysis

In the Preamble to the Proposed Regulations for Section 2801, Treasury refers to the Report of the House Ways and Means Committee stating that an individual's decision to expatriate should not affect the total amount of taxes imposed.[23] Consistent with this objective, Section 2801(e)(2) precludes the application of Section 2801 with respect to any transfer reported on a timely filed gift or estate tax return.[24] Absent such reporting, Section 2801(e)(1) will apply and tax under Section 2801 will be imposed on the recipient with respect to such property.[25] A covered expatriate's failure to timely file a gift or estate tax return with respect to a transfer of U.S. situs

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[19] Section 2801(e)(2)

[20] Prop. Treas. Reg. Section 28.2801-3(c)(1)

[21] Prop. Treas. Reg. Section 28.2801-3(c)(2)

[22] *See* H.R. Rep. No. 110-431 (2007)

[23] *Id.*

[24] Notably, the statutory language is silent with respect to timely payment, and a timely filed return will suffice for the exception to apply.

[25] Section 2801(b); *See* Prop. Treas. Reg. 28.2801-3(f) Example 2

property, triggering application of Section 2801, does not preclude the imposition of gift or estate tax on such transfer - such that there is a possibility of imposing a double tax.

Our proposed interpretation would preclude the application of Section 2801 with respect to any transfers of U.S. situs property, provided such transfer is reflected on a timely filed tax return. Accordingly, we recommend eliminating the following language from Prop. Treas. Reg. 28.2801-3(c)(1) and (2), respectively: "provided that the donor also timely pays the gift tax" and "provided that the estate also timely pays the estate tax." Alternatively, if the concern is that if there is no payment of the gift or estate tax, that such tax may never be paid, then the mechanism of double taxation may be too harsh. Perhaps Treasury may choose instead to provide a credit against the later paid tax (presumably the estate or gift tax) for the earlier paid tax (the Section 2801 inheritance tax). In this way, the tax is collected from one or the other source, but not both.

III. Determining Responsibility under Section 2801

A. Proposed Regulations

Section 2801(b) provides that the tax on covered gifts or covered bequests received by a U.S. citizen or resident under Section 2801(a) shall be paid by the person receiving such gift or bequest. Proposed Regulation Section 28.2801-7(a) provides that it is the responsibility of the taxpayer (i.e., the person receiving the covered gift or covered bequest) to ascertain the taxpayer's obligations under Section 2801. This Proposed Regulation goes on to provide that the taxpayer's obligations include making the determination of whether the transferor is a covered expatriate and whether the transfer is a covered gift or covered bequest.

B. Analysis

Under Section 2801(f), the term "covered expatriate" has the meaning given to such term by Section 877A(g)(1). Under Section 877A(g)(1) the term "covered expatriate" means an expatriate who meets the requirements of Section 877(a)(2)(A), (B), or (C), and under Section 877A(g)(2) the term "expatriate" means any U.S. citizen who relinquishes his or her citizenship and any long term resident of the U.S. who ceases to be a lawful permanent resident of the U.S. (under Section 7701(b)(6)). The term "long term resident" has the meaning given by Section 877(e)(2) (holding a green card for eight out of the fifteen taxable years preceding expatriation).

The requirements of Section 877(a)(2)(A), (B), or (C) are that the average annual net income tax liability of the individual for the period of five taxable years ending before the date of expatriation is greater than $124,000 (indexed for inflation), the net worth of the individual on the date of expatriation is $2 million or more, or such individual fails to certify that he or she has met the requirements of Title 26 for the five preceding taxable years or fails to submit such evidence of such compliance as the secretary may require.

Generally speaking it will not be difficult for a taxpayer who receives a covered gift or covered bequest to determine if the donor is an expatriate. In most cases the fact that the taxpayer is receiving a gift or bequest from the person will mean that the taxpayer is well acquainted with the person and will therefore know if that person had been a U.S. citizen or a long term resident. However, it will be very difficult for a taxpayer to know whether an expatriate is a covered expatriate. To determine if the expatriate meets the very specific definitions described above, the taxpayer would need to know significant details about the income tax filing status and net worth of the expatriate; such knowledge regarding even a close relative or friend is unlikely.

Section 6039G(a) provides that any individual to whom Section 877(b) or 877A applies for any taxable year shall provide a statement for such taxable year which includes the information described in Section 6039G(b). Among the information described in Section 6039G(b) is "such other information as the Secretary may prescribe." It is recommended that the Secretary issue regulations or a notice which requires the statement (which is provided on IRS Form 8854) to include a required authorization by the expatriate for the IRS to disclose to any U.S. person who receives a gift or bequest from the expatriate relevant return information to determine if the expatriate is a covered expatriate. If such a regulation or notice is issued, the first sentence of Proposed Regulation Section 28.2801-7(b) should be revised to provide that "the IRS shall, upon request of a U.S. citizen or resident in receipt of a gift or bequest from an expatriate, disclose to the U.S. citizen or resident return or return information of the donor or decedent expatriate that may assist the U.S. citizen or resident in determining whether the donor or decedent was a covered expatriate and whether the transfer was a covered gift or covered bequest."

Should the Proposed Regulations be revised as set forth above, it is also recommended that the rebuttable presumption of a covered gift or covered bequest provided in the first sentence of Proposed Regulation Section 28.2801-7(b)(2) be removed. Instead this section should include the second sentence thereof, which allows the taxpayer to file a protection Form 708 where the taxpayer reasonably believes that the gift or bequest is not subject to Section 2801.

Alternatively, if it is determined that the Secretary does not have authority to require on Form 8854 that the expatriate authorize disclosure of the information, then at a minimum the Form should give the expatriate the option to authorize such disclosure.

IV. Annual Exclusion Gifts

We agree with much of the discussion by the International Tax Planning Committee of the Income and Transfer Tax Planning Group of the Real Property, Trust & Estate Law Section of the American Bar Association in connection with the issues surrounding the operation of the annual exclusion on pages 27 through 29 of the paper that Committee prepared on expatriation and the Proposed Regulations. We would like, however, to highlight one topic that warrants further discussion: the annual exclusion as it relates to withdrawal powers.

A. Proposed regulations

Proposed Regulation Section 28.2801-3(d) provides that a covered gift from a covered expatriate is deemed made to a domestic trust, without regard to the beneficial interests in the trust or whether any person has a general power of appointment or a Crummey power. As discussed above, Proposed Regulation Section 28.2801-3(a) also provides that "the term gift as used in the definition of covered gift in §28.2801-2(g) has the same meaning as in chapter 12 of subtitle B…."

B. Analysis

When a beneficiary of a trust has a withdrawal power with respect to a transfer, then for gift tax purposes the power holder is deemed the donee. Therefore, given that the Proposed Regulations follow the gift tax rules for purposes of determining what constitutes a gift from a covered expatriate, then the Proposed Regulations should be consistent with the gift tax rules, and where a Crummey power exists, treat the Crummey power holder as the donee of a transfer to a trust for purposes of Section 2801.

At a minimum, if either the Crummey power holder is a U.S. person, or if the power holder actually exercises the power, and withdraws the funds from the trust, the gift should be deemed to be made directly to the power holder, thereby qualifying each donee for a separate $14,000 annual exclusion.

Respectfully,

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Chair
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