

Taxation of Covered Gifts and Bequests

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IRC §2801 taxes U.S. citizens or residents who receive gifts and bequests from covered expatriates, which would otherwise have escaped U.S. transfer taxes.

Internal Revenue Code (IRC) §2801 assesses an inheritance tax on U.S. citizens and residents that receive “covered gifts” or “covered bequests” from individuals that have expatriated from the United States. This article discusses when an IRC §2801 tax can be assessed and how the recipient of a covered gift or covered bequest must report the IRC §2801 tax to the Internal Revenue Service (IRS).

WHEN DOES AN EXPATRIATION POTENTIALLY TRIGGER AN IRC §2801 INHERITANCE TAX?

An IRC §2801 inheritance tax can only be assessed on a covered gift or covered bequest received from an individual expatriating from the United States. We will begin this article by discussing the type of expatriation that can trigger an IRC §2801 tax.

U.S. taxation of worldwide income entices U.S. citizens and long-term residents to renounce their U.S. citizenship or residency. Congress designed IRC §877A to prevent citizens and long-term residents from expatriating from the United States for tax purposes. IRC §877A authorizes a mark-to-market “exit tax” on certain covered expatriates. All property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.¹ A “covered expatriate” is any U.S. citizen or long-term resident (i.e., a permanent resident of the U.S. in at least 8 of the 15 taxable years ending with the taxable year of expatriation) who expatriates from the U.S.²

An expatriate who meets any of the following requirements is considered a “covered expatriate”:

1. **Tax Liability Test.** The expatriate’s average annual income tax liability for the 5 years before the date of expatriation exceeds a specified threshold, indexed annually for

inflation. The 2026 threshold is \$211,000. Net Investment Income Tax and Self-Employment taxes are not counted for this threshold. Married couples filing jointly cannot divide their tax liability for purposes of the \$211,000 threshold.

2. **Net Worth Test.** The expatriate must have a net worth of at least \$2 million as of the date of the expatriation.
3. **Certification Test.** An expatriate fails to certify under penalty of perjury that he or she has complied with all federal tax obligations for the five preceding tax years.

For the 2026 tax year, a covered expatriate’s mark-to-market gain exemption is \$910,000. This means that \$910,000 of gain is excluded from the exit tax. Some covered expatriates have used a gifting strategy to avoid the exit tax. In order to prevent covered expatriates from utilizing this strategy, the Department of Treasury finalized the proposed covered gift regulations. This article discusses the final covered gift tax regulations, how the governed gift tax is assessed, and the return that must be filed with the IRS to disclose a covered gift.

DEFINITION OF “COVERED GIFTS” AND “COVERED BEQUESTS” UNDER IRC §2801

In addition to the exit tax discussed above, IRC §2801 adds a new “inheritance

tax” on certain gifts or bequests made by “covered expatriates” to U.S. recipients. IRC §877A imposes the highest applicable gift or estate tax rate (40 percent) on U.S. citizens or residents who receive a so-called “covered gift or bequest” from an expatriating individual. IRC §2801 imposes an inheritance tax on the recipient of a gift from a covered expatriate.

The term “covered gift” means any property acquired by a gift directly or indirectly from an individual who is a covered expatriate at the time the gift is received by the U.S. recipient, regardless of the situs of the gift. “Gifts” has the same meaning as under the U.S. gift tax laws, but without regard to certain exceptions that would otherwise apply.³ A gift generally includes any property transferred during the donor’s lifetime for less than adequate consideration.⁴ Adequate consideration generally means the fair market value of transferred property. The fair market value of the property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having knowledge of relevant facts. Thus, if Mom sells Blackacre to Child for \$100, and Blackacre is actually worth \$250, Mom has made a gift to Child of \$150.⁵

The term “covered bequest” means any property acquired directly or indirectly by reason of death of a covered

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expatriate, regardless of its situs and of whether such property was acquired by the covered expatriate before or after expatriation from the United States.⁶ Thus, under Treas. Reg. §28.2801-2(f), a covered bequest includes acquiring property of a covered expatriate through a trust provision, beneficiary designation, or other contractual arrangement, or by operation of law, to the extent the property would have been includible in the covered expatriate's gross estate if the covered expatriate had been a U.S. citizen at death.

U.S. RECIPIENTS SUBJECT TO TAX UNDER IRC §2801

The IRC §2801 tax is only assessed on a U.S. recipient of a covered gift or bequest. A U.S. recipient is defined as a citizen or resident of the United States.⁷ The U.S. recipient is responsible for determining whether the donor or decedent is a covered expatriate and if the gift or bequest can be characterized as a covered gift or bequest.⁸ The U.S. recipient is also responsible for paying the IRC §2801 tax. A U.S. recipient will not always be an individual. A U.S. recipient can be a domestic trust or a foreign trust. A domestic trust that receives a covered gift or bequest will be responsible for paying the IRC §2801 tax.⁹

A charitable remainder trust that receives a covered gift or bequest is also required to pay the IRC §2801 tax. However, the portion of the covered gift or bequest that qualifies for a charitable deduction is excluded from the IRC §2801 tax. The charitable remainder trust must calculate the portion of the covered gift or bequest that is subject to the tax.¹⁰

A foreign trust can be treated as a U.S. recipient if the trust makes an election to be treated as a domestic trust or if the foreign trust has U.S. beneficiaries. An IRC §2801 tax assessed on a foreign trust is the ratio that reflects the portion of the trust attributable to covered gifts and bequests and the subsequent appreciation and income attributable to such covered gifts and bequests. This ratio is multiplied by the current distribution to a U.S. recipient to determine what portion of the distribution is attributable to a covered gift or bequest.¹¹

DO ESTATE AND GIFT TAX TREATIES OFFER RELIEF FROM THE COVERED GIFT OR COVERED BEQUEST TAX?

Neither the statutory language nor the legislative history of IRC §2801 provides any indication of Congressional intent concerning the effect of existing estate and gift tax treaties on the application of IRC §2801. In the absence of specific language overriding treaties, statutes generally are to work in harmony with existing treaties.¹² In other words, the way Congress enacted IRC §2801 and the Treasury finalized its regulations under IRC §2801, it remains an open question if an estate and gift tax treaty or an income tax treaty position can be taken to reduce or eliminate a covered gift or covered bequest tax. The effect of any estate or gift tax treaty or income tax treaty must be evaluated on a case-by-case basis.

HOW DOES THE COVERED INHERITANCE TAX OPERATE

The inheritance tax is payable by the recipient of the covered gift or bequest, not the expatriate. There is no expiration of the potential applicability of IRC §2801. Thus, a gift or bequest made by a covered expatriate several years (or longer) after expatriation could trigger the tax. The Inheritance Tax is imposed in addition to the mark-to-market tax paid by the covered expatriate upon exit. Currently, the tax rate imposed by IRC §2801 is 40 percent of the value of the gift or bequest. IRC §2801 taxes U.S. citizens or residents who receive gifts and bequests from covered expatriates, which would otherwise have escaped U.S. transfer taxes (as a consequence of the donor's expatriation). U.S. recipients of a covered gift or bequest are permitted a \$19,000 exclusion (for the 2026 calendar year) per donor as an annual exclusion from the IRC §2801 tax.

EXCLUSIONS

There are several exclusions from the IRC §2801 inheritance tax, including the following:

1. *Gifts already subject to U.S. Gift Tax.* If the covered gift transferred to the U.S. recipient was already subject

to the U.S. gift tax, the covered gift will not be subject to the IRC §2801 tax. For this exception to apply, the covered expatriate must have timely filed a gift tax return with the IRS and paid any applicable gift tax.¹³

2. *Bequests already subject to U.S. Estate Tax.* If a gift was already included in the gross estate of a covered expatriate for purposes of the U.S. estate tax and an estate tax return was timely filed and the estate tax was timely paid, the covered bequest will not be subject to the IRC §2801 inheritance tax.¹⁴
3. *Charitable Gifts.* A covered gift or covered bequest that qualifies for a charitable deduction is not treated as a covered gift or covered bequest for purposes of IRC §2801.¹⁵
4. *Valid Disclaimer.* A covered gift or covered bequest that was made to a U.S. recipient who made a valid qualified disclaimer is not subject to the IRC §2801 tax.¹⁶
5. *Transfers to Spouses.* Property transferred from a covered expatriate to the covered expatriate's spouse generally is not a covered gift or bequest to the extent a marital deduction under IRC §§2523 or 2056 would have been allowed if the covered expatriate had been a U.S. citizen at the time of the transfer. To the extent that a gift or bequest of property to a trust (or to a separate share of the trust) would qualify for the marital deduction, the property transferred in the gift or bequest is not a covered gift or covered bequest. To the extent the gift or bequest of property to the trust (or to a separate share of the trust) would not qualify for the marital deduction, the property transferred in the gift or bequest is a covered gift or covered bequest to the trust. In the case of non-electing foreign trusts, distributions attributable to such gift or bequest will subject the U.S. citizen or resident spouse receiving such distributions to IRC §2801.¹⁷ For qualified terminable interest property (QTIP) described in IRC §2056A, a valid QTIP and/or QDOT election must be made by the covered expatriate or covered

expatriate's estate in order for the gift or bequest of such property to qualify for the marital exclusion under IRC §2801(e)(3), and, thus not a covered gift or covered bequest.

See Example 1, which discusses how the marital transfer operates.

Example 1: In Year 1, CE, a covered expatriate domiciled in Country F, a foreign country that does not have a gift tax treaty with the United States, gives \$300,000 cash to his wife, W, a U.S. resident and citizen of Country F. The \$100,000 exclusion for a noncitizen spouse, as indexed for inflation in Year 1, is excluded from the definition of a covered gift under IRC §2801 because only that amount of the transfer would have qualified for the gift tax marital deduction if CE had been a U.S. citizen at the time of the gift. The remaining amount (\$300,000, less the \$100,000 exclusion for a noncitizen spouse, as indexed for inflation) is a covered gift from CE to W. W must timely file Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, and timely pay the tax. W must also report the transfer on Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, and any other required form.

Several estate and gift tax treaties (including the U.S.–Canada income tax treaty) provide for an unlimited or partial marital deduction. Significant planning possibilities exist for noncitizen spouses in the context of expatriation interspousal transfers that can take advantage of these treaties.

COVERED GIFT OR COVERED BEQUEST MAY BE SUBJECT TO IRC §2801 TAX AND U.S. ESTATE TAX

A covered gift or covered bequest may be subject to the IRC §2801 tax and the estate tax. See Example 2, which discusses how a transfer of property could be subject to both taxes.

Example 2: Year 1. CE, a covered expatriate in Country F, a foreign country with which the United States does not have an estate tax treaty, owns a condominium in the U.S. with son, S, a U.S. citizen. CE and S each contributed their

actuarial share of the purchase price with purchasing the condominium and they own it as joint tenants with rights of survivorship. On December 14, Year 1, CE dies. At the time of CE's death, the fair market value of CE's share of the condominium, \$250,000, is included in CE's gross estate under IRC §§2040 and 2103.

Year 2. On September 14 of the following calendar year, Year 2, the executor of CE's estate timely files a Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation Skipping Transfer) Taxes*, requesting a 6-month extension of time to file Form 706-NA, and a 1-year extension of time to pay the estate tax. The IRS grants both extensions, but CE's executor fails to file the Form 706-NA until after March 14 of Year 3.

Analysis. S learns that the executor of CE's estate did not timely file Form 706-NA. CE's estate remains liable for estate tax on CE's interest in the condominium. In addition, because CE is a covered expatriate and CE's estate failed to timely file the tax return reporting the transaction, S received a covered bequest and must file Form 708 and pay the §2801 tax. S also must file Form 3520 to report a large gift or bequest from a foreign person and any other required forms.

See Example 3, which discusses covered gifts in trust with a grant of general power of appointment over trust property.

Example 3: On October 20, Year 1, CE, a covered expatriate domiciled in country F, a foreign country with which the United States does not have a gift tax treaty, transfers \$500,000 in cash from an account in Country F to an irrevocable foreign trust created on the same date. The foreign trust does not elect to be treated as a domestic trust for purposes of IRC §2801. Under IRC §2511(a), no gift tax is imposed on the transfer and thus, CE is not required to file a U.S. gift tax return. Under the terms of the foreign trust, A, CE's child and a U.S. resident, and Q, A's child and a U.S. citizen, may receive discretionary distribution of income and principal during life. At A's death, the assets remaining

in the foreign trust will be distributed to B, CE's other U.S. resident child, or if B is not living at the time of A's death, then to CE's then-living issue, per stirpes. The terms of the foreign trust also allow A to appoint trust principal and/or income to A, A's estate, A's creditors, the creditors of A's estate, or A's issue at any time. On March 5, Year 2, A exercises this power to appoint and causes the trustee to distribute \$100,000 to Q.

Analysis. Since Q receives a distribution attributable to a covered gift, IRC §2801 is imposed on Q. Q must timely file Form 708 to report the covered gift from a foreign person (specifically from CE). Furthermore, because the \$100,000 is being distributed from a foreign trust, Q must report the gift on a Form 3520 as a distribution from a foreign trust.

See Example 4, which discusses the lapse of power of appointment by a covered expatriate.

Example 4: A, a U.S. citizen, creates an irrevocable domestic trust for the benefit of A's issue, CE and CE's children. CE is a covered expatriate, but CE's children are U.S. citizens. CE has the right to withdraw \$5,000 in each year in which A makes a contribution to the trust, but the withdrawal might lapse 30 days after the date of the contribution. In Year 1, A funds the trust, but CE fails to exercise CE's rights to withdraw \$5,000 within 30 days of the contribution. The \$5,000 lapse is not considered to be a release of the power by CE, so it is neither a gift for U.S. gift tax purposes, nor a covered gift for purposes of IRC §2801.

See Example 5, which discusses property subject to IRC §2801 tax as a covered gift and as a covered bequest.

Example 5: F, a covered expatriate, transfers an income interest in property to A, a U.S. citizen, while retaining the remainder interest. F was not required to, and did not, file a gift tax return. Upon F's death, A receives full title to the property. The initial transfer of the income interest was a covered gift valued at \$1,000,000, upon which A paid the IRC §2801 tax. The value of the property at F's death is \$4,500,000. Because the full value of the property would have been included in F's gross estate if F had died as a U.S. citizen, there is a covered bequest at F's

death. The covered bequest is subject to IRC §2801 tax on the excess of the value of the covered bequest over the value of the covered gift (\$4,500,000 - \$1,000,000 = \$3,500,000).

REPORTING AND COMPUTING GIFT OR INHERITANCE TAX

The IRC §2801 tax will be computed on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, on which a U.S. recipient will report covered gifts and covered bequests received during the calendar year. If the aggregate value of the covered gifts and covered bequests received by the U.S. recipient during the calendar year exceeds the inflation-adjusted annual exclusion under IRC §2503(b) (\$19,000 for 2026), the IRC §2801 tax is computed by multiplying the excess by the highest estate tax rate specified in IRC §2001(c) in effect on the date of receipt, and then reducing the product by any gift or estate taxes paid to a foreign country with respect to the covered gifts and covered bequests. The value of each covered gift and covered bequest is its fair market value as of the date of its receipt.

An IRS Form 708 must be filed for each calendar year in which a U.S. beneficiary

received a covered gift. The due date for filing Form 708 is the 15th day of the 18th month following the close of the calendar year in which the covered gift was received by the U.S. recipient. In certain cases, U.S. beneficiaries may also be required to disclose a covered gift on an IRS Form 3520. In general, a U.S. person's Form 3520 is due on the 15th day of the 4th month following the end of a person's tax year for income tax purposes, which, for individuals, is April 15th.

In addition to filing requirements, the regulations promulgated under IRC §2801 impose a recordkeeping requirement. Treas. Reg. §28.6001-1 provides that all documents and vouchers used in preparing Form 708 must be retained by the person required to file the return to be available for inspection by the IRS.

CONCLUSION

On September 10, 2015, Treasury issued proposed regulations for IRC §2801, which have since been finalized. The regulations apply to U.S. citizens or residents that receive gifts from a "covered expatriate" that can be classified as a "covered gift" or covered bequest.¹ The IRS could potentially retroactively assess IRC §2801 inheritance tax liabilities in connection with gifts and bequests

received from covered expatriates more than 10 years ago. The IRS could also demand that U.S. recipients of covered gifts or bequests file Form 708 for gifts received in prior years. At this point, it remains an open question if the IRS will examine prior covered gifts or bequests and attempt to assess the IRC §2801 tax.

End Notes

- ¹ IRC §877A(a)(1).
- ² IRC §877(e)(2).
- ³ Prop. Reg. §28.2801-3(a).
- ⁴ IRC §2511.
- ⁵ Treas. Reg. §25.2518-8.
- ⁶ Prop. Reg. §28.2801-2(f).
- ⁷ Prop. Reg. §28.2801-2(e).
- ⁸ Prop. Reg. §28.2801-7(a).
- ⁹ IRC §2801(e)(4)(A).
- ¹⁰ IRC §2801(e)(4)(B)(iii).
- ¹¹ Prop. Reg. §28.2801-5(c)(1)(i).
- ¹² IRC §7852(d).
- ¹³ IRC §2801(e)(2)(A).
- ¹⁴ IRC §2801(e)(2)(B).
- ¹⁵ IRC §2801(e)(3).
- ¹⁶ Prop. Reg. §28.2801-3(c)(5).
- ¹⁷ Treas. Reg. §§28.2801-4(a)(3) and 2801-5(a).