
NAEPC
Journal
of Estate & Tax Planning
Click here to view Issue 29

Bloomberg Tax

TAX PLANNING INTERNATIONAL

EUROPEAN TAX SERVICE

International Information for International Business

MAY 2018

www.bna.com

Tax Tribulations for American Royalty

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The royal wedding in St George's Chapel at Windsor Castle, outside of London, was quite the media event. Now, the marriage festivities are over, the honeymoon has started, but with it starts a whole new set of U.S. tax problems for Meghan Markle, HRH The Duchess of Sussex, and the new bride of Prince Harry, the new Duke of Sussex. She'll just have to face it: It can be difficult being American Royalty.

Where do those tax problems start? For one, the United States, being out of synch with most of the rest of the world, taxes its citizens on their worldwide income, gifts and estates, regardless whether they reside in the U.S. or not; with worldwide taxation come a host of potential reporting obligations. The problems just start with foreign bank account reporting ("FBAR") for foreign financial accounts with more than US$10,000 in them. The State Department in 2016 estimated that there are 9 million U.S. citizens living abroad.

For Meghan, gifts could present an issue, as can merely having the Queen arrange for her to borrow that diamond tiara or Meghan's living on a sumptuous royal estate. Meghan will want to determine the owner of that jewelry she borrows from the Queen or that royal estate where she lives. If the property she uses is actually in trust for the Royal Family, Meghan's tax exposure is much greater then. While the Supreme Court's 1984 decision in *Dickman v. Commissioner*, 465 U.S. 330, certainly can be read to extend to uncompensated loans of jewelry and real property, the case dealt with interest-free loans of cash. However, the IRS has not tried to further extend the holding and Congress stepped in to legislate the tax treatment of interest-free and below-market loans, by enacting Code Section 7872. Congress did, however, step in also to legislate the tax treatment of Americans' loans of funds and the use of property from foreign trusts, as a distribution from the foreign trust of the loan proceeds (other than certain exempt loans) or a distribution of the fair market value of the use of the property. If the trust has current or accumulated income, Meghan may realize taxable income.

There are penalties for the failure to report foreign trust distributions. Further, Form 3520, which is used to report such foreign trust distributions is also used to report gifts from foreigners. A failure to report a

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 TPETS ISSN 1754-1646

foreign trust distribution risks a penalty equal to 35 percent of the unreported distribution; the penalty for a failure to report gifts from foreigners (generally when the total gifts in a year are US$100,000 or more) is up to 25 percent of the gift not reported.

If Meghan is feeling generous and wants to make a gift to Prince Harry, now that they are married, she is limited to annual gifts of US$152,000 (2018) to a nonresident alien spouse before they start being counted against her lifetime estate and gift tax exemption amount (US$11,180,000 under the 2017 tax reform legislation, as adjusted for 2018). Before marrying, she was subject to a US$15,000 2018 limit on her annual gifts to her betrothed. If Prince Harry made U.S. situs gifts (e.g. gifts of U.S. real estate or his gifts *in the United States* of jewelry and other personal property) to Meghan prior to their marriage, he has his own potential gift tax exposure, if his gifts during the year were worth more than US$15,000. Now married, Prince Harry can take advantage of the unlimited spousal gifting exemption for his gifts (and bequests upon death) to his U.S. citizen spouse.

Giving up one's U.S. citizenship is one way for Meghan to consider to cut the tax knot that comes from worldwide taxation on the basis of citizenship. However, since the addition of section 877A to the Code in 2008, a complex expatriation "exit tax" regime exists that can potentially ensnare Americans giving up their U.S. citizenship. As a general rule, this regime treats a "covered expatriate" (i.e., an expatriating U.S. citizen as well as certain defined "long-term" green card U.S. tax residents, provided certain threshold requirements are met) as if he or she sold their global assets and recognized their gain in those assets. Such gain from the deemed sale is taxable to the extent it exceeds a US$713,000 exclusion amount (2018). Further, U.S. citizens and residents incur tax liability on gifts and bequests from covered expatriates, reversing the normal rule that our gift and estate taxes are imposed on the donor or the decedent's estate.

An expatriating citizen (and long-term green cardholder) can avoid being a covered expatriate, if:

- the individual's net worth is at less than US$2 million;
- his or her average annual net income tax liability for the five years preceding expatriation is less than US$165,000 (2018 inflation-adjusted figure); and
- he or she certifies meeting all federal tax obligations for the five prior years.

Of course, it may be a bit before Meghan qualifies for U.K. citizenship and she does not want to become stateless by giving up her U.S. citizenship prior to acquiring her U.K. nationality (or the nationality of another convenient third country, such as Malta, a former outpost of the British Empire).

Finally, these U.S. tax problems may be visited upon Meghan and Prince Harry's offspring. Even if born in England, it is possible that Meghan's children with Prince Harry will be U.S. citizens faced with the same problems Meghan faces. She might just ask former London Mayor Boris Johnson, about the problems being a U.S. citizen in England caused him and eventually led him to renounce his U.S. citizenship.

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