

## MEDIA ADVISORY: Will the IRS Know What Gifts Prince Harry Gives Meghan Markle for Christmas?

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*Caplin & Drysdale, Chartered*

The recent engagement of Prince Harry and Meghan Markle raises an intriguing question regarding the distinction between marital support and gifts. One may initially find this a pedantic inquiry, but it is a question that frustrates planning for many international tax practitioners advising couples with one U.S. spouse and one non-U.S. spouse.

A U.S. citizen or resident alien ("U.S. person") is subject to worldwide taxation and a host of international information reporting obligations. A few are likely on the forefront of the minds of Ms. Markle's tax and financial advisors:

1. Ms. Markle must report income generated by all assets, regardless of where held. If she holds property jointly with Prince Harry, and that property produces income, at least part of it must be reported on her U.S. Form 1040.
2. Ms. Markle must report her interest in all non-U.S. financial assets on Form 8938 if the aggregate value of those assets exceeds \$200,000 on the last day of the year, or \$300,000 on any day of the year. (This threshold applies to her because we presume she and Prince Harry will not file a joint Form 1040.)
3. Additionally, Ms. Markle must file a yearly Foreign Bank Account Report (FBAR) if the value of her direct/indirect interest in or signatory authority over any non-U.S. financial accounts exceeds (in the aggregate) \$10,000 at any point during the year.

In addition to the reporting requirements listed above, Form 3520 may prove the most interesting and potentially complex filing requirement that applies to Ms. Markle. As a U.S. person, Ms. Markle must report gifts from a non-resident alien individual, and those from others related to such person, that exceed \$100,000 in the aggregate.

Victor Jaramillo, Of Counsel at Caplin & Drysdale, provides an example of this rule: "If Ms. Markle's engagement ring exceeds \$100,000 in value, she must report this gift on Form 3520. Because she is also required to aggregate gifts from persons related to Prince Harry, she must also report any gifts received from the Queen in that same year, even if it is merely a \$500 brooch. The requirement to report gifts from related persons can bring about interesting (and perhaps absurd) consequences."

Non-tax readers may believe that Ms. Markle's obligation to track all gifts from Prince Harry and those related to him would end when the couple marries in 2018. However, as Caplin & Drysdale Member Dianne Mehany explains, this is not the case. "Transfers from a non-U.S. spouse to a U.S. spouse are not exempt from this relatively low reporting threshold. Moreover, 'gifts' could be broadly interpreted as including items of marital support. Regular items such as a car, a vacation, or even an anniversary dinner could be classified as reportable 'gifts' from a foreign person to a U.S. person. It is almost certain that Ms. Markle will be required to file Form 3520 in the upcoming years, and perhaps has already filed one for the 2016 year."

Failure to file the form subjects Ms. Markle to a penalty of 5% of the value of the gift for each month in which she fails to file the Form, but the penalty is capped at 25%. So, if she does not file the Form within 5 months of the due date, the IRS could impose a penalty of 25% on the value of the unreported gifts.

This reporting requirement highlights two further areas of concern among tax practitioners.

1. Is there a distinction between a gift and marital support? Must Ms. Markle report groceries or use of Prince Harry's homes as a gift?

While an exception to the definition of "gift" exists for qualified tuition and medical payments, no exception exists for payments related to marital support.

1. Are the lines blurred between "gifts" and "income" for Ms. Markle in relation to her Royal Duties?

When Ms. Markle embarks on humanitarian trips, paid for by the Royal Family or the British people, is she earning income for her "services" to the Crown, or is she receiving a reportable gift in the form of an all-expenses paid vacation? Regardless of the classification as income, a gift, or something else, Ms. Markle's reporting requirements to the U.S. will be compounded exponentially once she and Prince Harry marry.

The unduly burdensome reporting process may entice Ms. Markle to expatriate once she obtains U.K. citizenship. This in and of itself will likely prove costly. As Ms. Mehany explains: "Ms. Markle is a noted actress and wealthy woman in her own right. If her average tax liability over the past five years exceeds \$162,000 or her net worth exceeds \$2 million, she would be liable for the draconian 'exit tax' imposed by the U.S. on persons relinquishing U.S. citizenship. She would be taxed on the fictional gain from the deemed sale of her worldwide assets on the day before she expatriates." Mr. Jaramillo added: "Since she would not become a U.K. person for at least a few years, those assets will likely include assets from the Royal Family by the time she expatriates. And, how do you value a tiara received from the Queen? What is the fair market value of that?"

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