

The U.S. TAXFAX

TOPIC: U.S. ESTATE TAXES FOR NON RESIDENTS OF THE UNITED STATES.

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This edition of the U.S. TAXFAX will discuss the estate tax rules and how they can impact U.S. non-residents investing in the U.S..

Property Subject to Estate Taxes:

U.S. federal estate taxes are generally based on the value of property owned at the time of death. For a non-resident, who is not a U.S. citizen, (i.e. non resident alien) the value of property situated in the U.S. at the time of death is subject to U.S. estate tax. The following property is considered situated in the U.S.:

- **Real Property** (e.g. real estate) located in the U.S.,
- A **debt obligation** of a citizen or resident of the U.S., a domestic partnership or corporation, any domestic estate or trust, or the U.S. government or State, or
- **Shares** of stock issued by a U.S. domestic corporation.

It should be noted that deposits with a U.S. bank are not included in the taxable estate of a non resident as long as the deposits are not connected with a U.S. trade or business.

The Calculation of Estate Taxes:

Estate tax is applied on the decedents taxable estate. The taxable estate is calculated as the gross value of U.S. property less deductions allocated to the U.S. estate such as funeral and administration expenses, accounting fees and certain debts related to the U.S.

property. The estate's value is determined on one of two dates: The date of death or, if the required election is filed, the alternate valuation date which is six months following. The gross estate tax is then calculated at marginal rates that range from 18% for estates under \$10,000, to 55% for estates in excess of \$3,000,000.

The following credits are deducted from the gross estate tax to determine the net estate tax payable:

- The unified credit,
- Credit for State death taxes,
- Credit for gift taxes, and
- Credit for tax on prior transfers.

The allowable unified credit depends on whether the decedent was a U.S. resident or non resident alien. A non-resident alien's estate is generally entitled to a unified credit of \$13,000, while a resident alien's estate is entitled to a credit of \$192,800. The \$13,000 credit represents the estate tax due on an estate valued at \$60,000.

The November 8, 1995 protocol to the Canada - U.S. tax treaty (The Protocol) substantially reduced the impact that estate taxes have on Canadian residents owning U.S. property. The protocol overrides the Internal Revenue Code provisions and will often grant Canadians with U.S. property a unified credit greater than \$13,000. Amongst other things, the Protocol also provides a mechanism whereby estate tax is deferred on property transferred to a spouse. Please refer to the third edition of the U.S. TAXFAX for further details regarding the protocol.

Filing Requirements:

If the value of a non-resident alien's gross estate is greater than \$60,000, the executor of the estate must file Form 706NA, U.S. Estate Tax Return, within 9 months of the date of death. An extension of time to file the return, or pay the tax, may be requested by filing Form 4868, Application of Automatic Extension of Time to File U.S. Individual Income Tax Return, before the return is due.

An estate tax return must be filed even if the tax liability is reduced to zero through the utilization of deductions and/or credits. A treaty disclosure statement must be filed with the estate tax return if the treaty protocol reduces the decedent's estate tax liability.

Estate Planning:

Non residents are often able to organize their affairs in such a way as to eliminate or reduce U.S. estate taxes.

U.S. non-residents can avoid estate taxes by purchasing U.S. property through a Canadian corporation. As shares of foreign corporations are not considered U.S. property, they are not subject to U.S. estate taxes. It should be noted that while this structure provides relief from U.S. estate taxes, it could result in higher overall income tax liabilities on an ongoing basis if the property is a business or revenue property.

Another means by which estate taxes can be avoided is by making inter vivos gifts of **intangible** property. The most common type of intangible property are shares in U.S. domestic corporation. Non-resident aliens can gift shares in U.S. corporations without any U.S. gift or income tax consequences. It should be noted that gifting **tangible** U.S. properties (e.g. U.S. real estate) would subject the giftor to the U.S. gift tax rules.

A third method used to minimize estate tax liability is through the joint ownership of tangible property. If a non-resident owns property jointly, only the portion in his or her name is subject to estate tax. The downside to this type of ownership is the increased annual compliance costs that can result when revenue properties are owned jointly.

A fourth method used to minimize or avoid U.S. estate taxes is to own the U.S. property through an irrevocable trust. The establishment and ongoing

compliance costs associated with a trust make this alternative worthwhile only if the U.S. investment is substantial.

Miscellaneous:

Foreign Tax Credit in Canada: The protocol to the treaty provides that U.S. estate taxes will be considered an income tax for purposes of calculating the foreign tax credit on the Canadian terminal return. This means that in cases where there are accrued gains on the U.S. property at the time of death, the Canadian income tax liability can often be reduced by the full amount of the U.S. estate taxes paid.

Responsibilities of Executor: The estate of the decedent is liable for the tax. If, however, the estate does not pay the tax, or miscalculates the tax, and the decedent was a non resident at the time of death, the executor can be held liable for any unpaid tax. As a result, it is important that the executor complies with the U.S. requirements and receives a clearance certificate from the IRS prior to distributing the estate's assets to the beneficiaries.

State Taxation: Many states have some form of estate or death tax which they apply on tangible U.S. property located within their borders. Furthermore, as the states are not bound by the Canada - U.S. tax treaty, it is possible for an estate to have a state liability even though its federal liability is nil.

The above discussion very briefly covers the non-resident estate tax area. The next U.S.TAXFAX will address gift and estate tax rules from the perspective of U.S. citizens living in Canada.

Please remember that the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained herein.