

## FOREIGN INDIVIDUALS AND THE U.S. ESTATE TAX (SIMILAR TO AN INHERITANCE TAX)

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The U.S. federal government has a very strong and potentially costly estate tax which is similar to an inheritance tax since it arises at death.<sup>1</sup> This tax is unlike any tax that exists in Mexico, or in many other countries outside of the U.S. For this reason, many foreign individuals do not understand the costs, risks, and tax implications of owning property or doing business within the U.S. The specific focus of this article is to discuss some of the costs, risks, and tax implications to foreign individuals of the estate taxes that exist in the U.S.

The estate tax becomes effective upon the death of an individual.

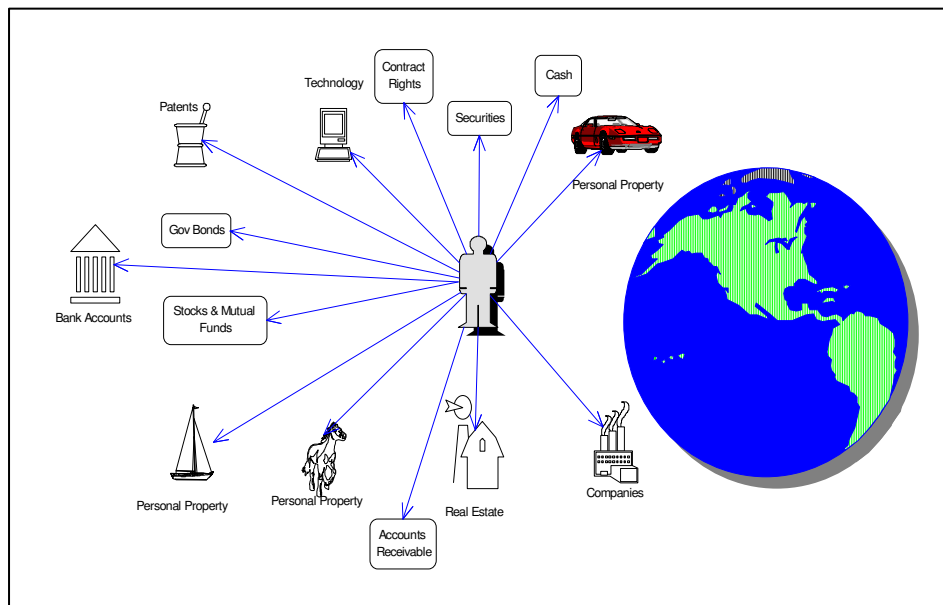
Currently, the U.S. federal estate tax rates range from 18 percent upon the first USD \$10,000 of taxable transfers and continues to increase to a rate of 55 percent.<sup>2</sup> The cost of this tax can be enormous and if not properly planned for, the family members and heirs of an individual will not be able to receive the primary value of these properties and instead the administrator of the estate will be required to pay over a large portion of the estate to the U.S. federal government in the form of the estate tax.

In addition to the federal estate tax, many States within the U.S., such as California and Texas have a separate estate taxes that apply to properties located within these States.

### ON WHOM DOES THE HIGH COSTS OF THE U.S. ESTATE TAX FALL?

The U.S. estate tax applies to all U.S. citizens, all non-U.S. citizens who permanently reside in the U.S., and to all non-U.S. citizens who do not permanently reside in the U.S. but have "U.S. situs property" located in the U.S. upon their death.

The amount of the estate tax that must be paid by an individual's estate depends upon number of variables, especially including the value of the property owned and the location of the property at the date of death. Careful estate tax planning can help preserve wealth and property that has been accumulated, through many years of hard work, within a family or business.



### CITIZENS AND OTHER PERSONS PERMANENTLY RESIDING IN THE U.S.

U.S. citizens and persons who are permanently residing in the U.S. are subject to the estate tax on their worldwide estate. In other words, if a person in this category has property throughout the world (whether it is located in the U.S., Mexico,

1. Internal Revenue Code ("I.R.C.") Section 2001, et. seq.  
2. I.R.C. Section 2001(c).

Central America, South America, the Caribbean, Europe, Asia, Africa, or any other place) almost all of this worldwide property is used to calculate the estate tax owed.

This draconian tax result, means that a non-U.S. citizen, such as a Mexican citizen, can be subject to the U.S. estate tax on all of their property (whether it is located in Mexico, the U.S., or other parts of the world) if they permanently reside in the U.S.

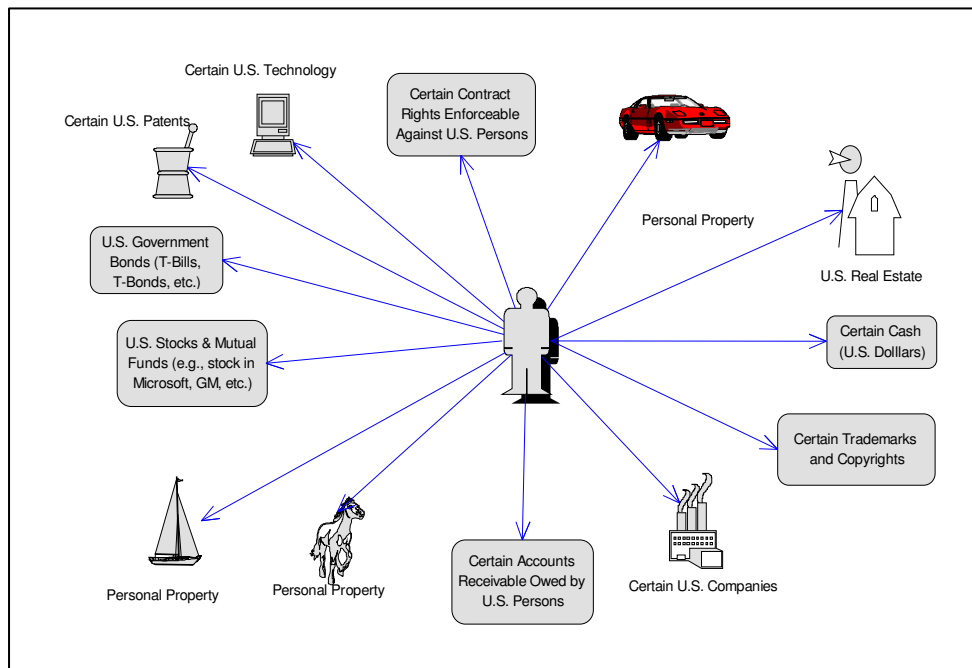
### NON-U.S. CITIZENS WHO DO NOT PERMANENTLY RESIDE IN THE U.S.

Persons who are not U.S. citizens and do not permanently reside in the U.S., are still subject to the estate tax on their "U.S. situs property."

- **What is deemed to be U.S. situs property of a foreign individual?**

All of the following property that is owned directly by the foreign individual will be subject to the U.S. estate tax: Most all personal property physically located in the U.S. (e.g., automobiles, art, boats, animals, jewelry, etc.);

- Most all personal property physically located in the U.S. (e.g., automobiles, art, boats, animals, jewelry, etc.);
- Stock of a U.S. corporation (e.g., stock in a closely held California corporation, Microsoft stock, IBM stock, stock of a family owned Texas corporation, GM stock, etc.);<sup>3</sup>
- Debt obligations of U.S. persons (including certain governmental entities) owned by the foreign individual. This includes accounts receivable from a U.S. person or company, certain government bonds, and promissory notes owed by U.S. companies or U.S. individuals, etc.;<sup>4</sup>
- Other intangible properties such as contractual rights, goodwill, judgment debts, partnership interests, trust interests, patents, trademarks, and copyrights may be U.S. situs property (" . . . if . . . issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit");<sup>5</sup> and
- All real estate located in the U.S. such as apartment buildings, office buildings, houses, ranches, factories, etc.



3. I.R.C. § 2104(a).

4. I.R.C. § 2104(c); Treas. Reg. § 20.21041(a)(7).

5. Treas. Reg. § 20.21041(a)(4).

Fortunately, most U.S. bank deposits, certain U.S. government bonds and proceeds from U.S. life insurance are not included as "U.S. situs" property and therefore not subject to the U.S. estate tax.

## CALCULATING THE U.S. ESTATE TAX FOR FOREIGN INDIVIDUALS

There are certain deductions that are available to the estate before the estate tax is imposed.<sup>6</sup> These deductions include certain expenses, losses, indebtedness, and taxes owed by the estate.<sup>7</sup> However, foreign individuals who do not permanently reside in the U.S. usually can take certain deductions only if they first account for their worldwide assets. This means that the worldwide assets must be reported to the U.S. government and then a deduction is only available based upon an allocation of the expenses based upon the value of the U.S. situs property in relation to the worldwide assets.

There are also additional deductions for certain transfers for public, charitable, and religious purposes.<sup>8</sup> Plus, there may be a so-called "marital deduction" if the surviving spouse is a U.S. citizen.<sup>9</sup>

### ▪ Estate Tax Rates

After the above deductions are taken, the estate tax rates are then imposed upon the total U.S. situs estate. As explained above, the estate tax rates are progressive and range from 18 percent upon the first USD\$ 10,000 for taxable transfers and continue to increase up through a 55 percent estate tax rate for amounts in excess of USD\$ 3,000,000.

The preliminary estate tax is then reduced by a mere USD\$ 13,000 estate tax credit (which corresponds to the USD \$60,000 exemption equivalent for foreign estates compared to the more generous exemption equivalents for U.S. estates of up to USD\$ 1,000,000).<sup>10</sup> Other less common tax credits may also be available.

## COLLECTION AND ENFORCEMENT OF ESTATE TAXES

Under U.S. law the executor of a nondomiciliary's estate is personally liable to the U.S. government for the U.S. estate taxes owed.<sup>11</sup> The executor must file an estate tax return (IRS Form 706 NA) showing the amounts of estate taxes owed.<sup>12</sup>

This return must be filed within nine months after death.<sup>13</sup>

If the estate taxes are not paid, the U.S. government can usually seize property of the estate or the executor without obtaining a court order in order to pay for the outstanding estate taxes not paid.

Plus Mexico and the U.S. have entered into an *Agreement for the Exchange of Information with respect to Taxes*. This Exchange of Information Agreement applies to the U.S. estate taxes and is designed to help both governments obtain information relating to tax liabilities owed to either the U.S. or Mexican governments and the location of assets. Under this Exchange of Information Agreement the IRS can request the Mexican Secretary of Finance and Public Credit to cooperate in obtaining information regarding the nondomiciliary estate's assets in Mexico.<sup>14</sup>

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6. I.R.C. § 2106(a).

7. I.R.C. §§ 2106(a)(1), 2053, and 2054.

8. I.R.C. § 2106(a)(2).

9. I.R.C. §§ 2106(a)(1) and 2056(d).

10. I.R.C. §§ 2102(c) and 2001(c)(1).

11. 31 U.S.C. § 3713(b).

12. Estate tax lien arises against the property included in the taxable estate of the decedent, and continues for a period of ten years after the date of death. The IRS does not have to make any assessment, recording, or filing, for this "silent" lien to become effective which gives the IRS a right to an interest in the property. I.R.C. § 6324(a)(1). *Detroit Bank v. United States*, 317 U.S. 329 (1943).

13. I.R.C. § 6075(a).

14. If the U.S. government so requests, under the Exchange of Information Agreement Mexico would be required to provide the following information and items about a taxpayer (presumably including an estate) and the taxpayer's financial affairs to the U.S. government, if such acts are not otherwise prohibited by the domestic laws of Mexico:

... books, papers, and records and other tangible property of the taxpayer;

... examine the individuals producing the books, papers, records and other tangible property; and

... determine the authenticity of books, papers, records and other tangible property.

Although each country must assist the other country in obtaining information about taxpayers, as discussed above, the Exchange of Information Agreement does not have any mechanism by which one country is obligated to enforce the taxes imposed by the other

## ESTATE TAX PLANNING OPPORTUNITIES

The above explanation of the U.S. estate tax shows just how dramatic and costly it can be to a foreign individual with U.S. situs property. Fortunately, there are many steps and planning opportunities that can be taken to minimize or eliminate any U.S. estate tax liability that otherwise might fall upon a foreign individual.

Depending upon the exact facts and circumstances of a particular case some of the following tax planning steps may be available to reduce or eliminate the estate tax:

- Avoiding permanent residency (domicile) in the U.S.
- Restructuring and owning property in a fashion so that it is not U.S. situs property.
- Making certain qualified gifts of property prior to death.
- Transferring certain properties into certain legal entities (utilizing certain common law trusts).
- Operating U.S. businesses directly or indirectly through foreign corporations or other legal entities.
- Obtaining certain U.S. loans or other debt to reduce the taxable value of the estate.
- Utilizing life insurance and take financial planning steps with U.S. financial accounts.

These type of estate tax planning opportunities need to be carefully considered on a case by case basis and coordinated with U.S. income tax planning techniques and opportunities.

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*country. The primary purpose of the Exchange of Information Agreement is to enable the enforcement of the taxing state's obligations against its own citizens and entities abroad.*