

Practical Pointers to Obtain the U.S. Foreign Death Tax Credit

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With the rise of internationalization, the use of the U.S. foreign death tax credit (the “Credit”) has grown. The Credit is available for U.S. citizens or residents to avoid double taxation of certain property located outside of the United States at death. The Credit applies to a transfer of property at death that is subject to a transfer tax substantially similar to the U.S. federal estate tax levied by the foreign country, state, jurisdiction, or political subdivision based on the property’s location in that foreign jurisdiction. For purposes of this article, the terms “foreign country,” “state,” “jurisdiction,” or “political subdivision” are used interchangeably. The Credit’s usefulness has increased as society has globalized and advances in technology have made the world smaller. Despite the Credit’s enlarged role in estates, guidance for the Credit’s use from the IRS, the Department of the Treasury, and the courts is scarce. This article offers some practical pointers to obtain the Credit.

Extra Time Involved

The first point to emphasize, after realizing that there is property located outside the United States that may be subject to tax in the United States and a foreign jurisdiction, is that obtaining the Credit will take significant extra time. Extra time will be needed for (1) the additional steps to determine what foreign taxes may apply and if those taxes qualify for the Credit, (2) completing Schedule P of the U.S. Estate (and Generation-Skipping Transfer) Tax Return (Form 706) (the “706”), (3) converting foreign currency into U.S. dollars, (4) translating into English the documents to file with the 706, (5) preparing and filing the Certificate of Payment of Foreign Death Tax (Form 706-CE, the “706-CE”), and (6) paying the foreign tax. For advisors who do not automatically extend the time for filing the 706, it may be wise to file for an extension of time to file the 706 in order to accomplish all of these tasks.

Use Local Counsel

Another aspect of obtaining the Credit that will take additional time and money is employing legal counsel in the jurisdiction where the foreign property is located, in order to facilitate qualifying for the Credit and identifying any nontax-related issues, such as an ancillary probate. The assistance of counsel familiar with the foreign jurisdiction’s taxes and laws will be needed to (1) determine what taxes may apply to the property, (2) pay those taxes, and (3) file the 706-CE, including having the foreign taxing authorities certify the 706-CEs and send them to the IRS. Although finding local counsel may be as easy as calling a tax partner in the firm’s local office, most advisors do not work in firms with offices across the world, and, even if they do, the local counsel may not be familiar with the local death tax laws or be able to convey them coherently to the U.S. advisor. Similarly, it may also be wise to hire a

competent translator to assist throughout the process of obtaining the Credit. Involving local legal counsel (and, if needed, a translator) may take significant time up front but should prove invaluable for obtaining the Credit.

Qualifying for the Credit

After allowing for extra time to obtain the Credit and enlisting local counsel, the threshold issue will be to determine if any taxes in the foreign jurisdiction qualify for the Credit. Taxes that qualify for the Credit are estate, inheritance, legacy, or succession taxes actually paid to a foreign country, state, jurisdiction, or political subdivision concerning property (1) located in that country and (2) included in the U.S. gross estate of a decedent who was a U.S. citizen or resident at death. The term “foreign country” includes a possession of the United States, such as Puerto Rico. Treas. Reg. § 20.2014-1(a)(1); PLR 8221079. The Credit is available only to U.S. citizens or residents with property situated in a foreign country that imposes an estate, inheritance, legacy, or succession tax.

Determining Creditability of the Foreign Tax

While the availability of the Credit seems straightforward, the creditability of the foreign tax is not, because of the dearth of guidance defining an estate, inheritance, legacy, or succession tax. First, the decedent has to be a U.S. citizen or resident at death. Second, the situs of the property has to be in the foreign country imposing the tax for which the Credit will be claimed. The situs of property is generally determined in a manner similar to the determination of U.S. situs of a nonresident alien’s property for U.S. estate tax purposes, except as may be modified by a U.S. estate tax treaty, to avoid double taxation. IRC § 2014(a). For example, real property is situated in the country where the property is located, while shares of stock and bank accounts are not usually deemed to be situated in the foreign country imposing the tax. Treas. Reg. § 20.2014-1(a)(3). Shares of stock are situated in the foreign country imposing the tax only if the corporation represented by the shares was incorporated in that foreign country. *Id.* A bank account located in a foreign country that imposes a tax will have a situs of the decedent’s domicile. *Id.*

The third part for the availability of the Credit—defining an estate, inheritance, legacy, or succession tax—is largely left to interpretation because there is little guidance describing which foreign taxes are estate, inheritance, legacy, or succession taxes. Different countries have different tax systems, and the taxes of countries outside the United States do not fit neatly into the U.S. version of an estate, inheritance, legacy, or succession tax. The seminal ruling defining what is a creditable tax against the U.S. federal estate tax is not very informative because it is short and specific to the foreign tax at issue in the case, the Canadian tax on capital gains. Rev. Rul. 82-82, 1982-1 C.B. 127. In that ruling, the IRS stated that the foreign tax, as characterized under U.S. law, must be substantially similar to an estate, inheritance, legacy, or succession tax to qualify for the Credit. *Id.* Furthermore, the IRS explained that the foreign tax must be levied on the transfer of the property and not on the appreciation of the property during the decedent’s lifetime. Under U.S. law, it is clear that a tax on the appreciation of an asset is more similar to an income tax than a transfer tax that would qualify for the Credit. If the property being transferred at death would be taxed despite any depreciation or appreciation, then the tax would seem to be similar to a succession tax, which would qualify for the Credit.

Explanation of Foreign Taxes by Local Counsel

Assistance of local counsel will help when making a determination of the creditability of the foreign taxes. The local counsel can explain the various foreign taxes that may apply to the property at death, including taxes imposed on national, state, and local levels, all of which may qualify for the Credit. From this explanation, the U.S. advisor can compare the foreign taxes to the relevant U.S. taxes. Those foreign taxes that are substantially similar to an estate, inheritance, legacy, or succession tax should qualify for the Credit.

Treaty-Based Qualification

The taxes that qualify for the Credit because the taxes are described in a U.S. estate tax treaty with another country to avoid double taxation of the property are much easier to identify. The United States has estate tax treaties with numerous countries, including the ones listed on the 706-CE: Australia, Austria, Canada (Article XXIX of the United States-Canada Income Tax Treaty), Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland, and the United Kingdom. An extensive list of U.S. treaties can be found in Ernst & Young's *2013 International Estate and Inheritance Tax Guide*. These treaties generally use exemptions and credits to eliminate double taxation of property located outside the decedent's country of domicile.

Collection of Receipts for Foreign Death Taxes Paid

Even if the foreign taxes qualify for the Credit, the Credit is granted only on proof of payment. Obviously, this means that the taxes not only have to be paid but also proven to be paid. To prove that the taxes were paid, the 706-CEs have to be submitted to the foreign taxing authorities. In addition, those authorities must certify that the taxes were paid and file the 706-CEs with the IRS.

Collecting all receipts and records, including any foreign tax returns filed, is necessary to provide evidence of the payment. These tax records may be used as support for the 706 and as a reminder to the foreign taxing authorities certifying the 706-CEs. If the foreign taxing authorities refuse to certify the 706-CEs, the foreign tax return and either the tax receipts or cancelled checks for the taxes paid must be filed with the IRS to obtain the Credit.

Local counsel can help determine which foreign taxing authorities need to be paid and ensure that the proper documentation is kept to evidence the payments.

Limitation on the Credit

The Credit is not always for the full amount of foreign death tax paid. The Credit is limited to the smaller of (1) the amount of the foreign death tax attributable to the property situated in the country imposing the tax and included in the decedent's gross estate or (2) the amount of the U.S. federal estate tax attributable to certain property situated in a foreign country, subject to foreign death tax in that country and included in the decedent's gross estate. IRC § 2014(b).

The formulas for the limitations are below. The limitations have two main differences. The first limitation effectively limits the Credit to the foreign tax attributable to the property that is subject to both U.S. and foreign death tax, and the second limitation limits the Credit based on U.S. estate tax values. For multiple foreign death taxes or tax rates, the first limitation is calculated separately for each tax

and rate, with the quotients totaled to obtain the first limitation amount. Treas. Reg. § 20.2014-2(b). In contrast, the second limitation is only calculated once, even if multiple foreign taxes or rates apply. Treas. Reg. § 20.2014-3(d). These limitations are applied on Schedule P of the 706.

Schedule P

General Practical Matters

Schedule P of the 706 shows the calculation of the Credit, including any limitation that may apply. Most of Schedule P is fairly straightforward, though preparing it has a few notable aspects. A separate Schedule P should be attached to the 706 for each country for which the Credit is being claimed, resulting in separate calculations of the Credit for different countries.

Although the Credit will not be granted until payment of the foreign death tax has been evidenced by the 706-CE filed with the IRS, estimated amounts of foreign death taxes paid may be used on Schedule P. The limitations period for claiming the Credit is the later of (1) four years after the filing of the 706, before the date of expiration of any extension of time for payment of the 706, or (2) 60 days after the final decision of the U.S. Tax Court on a timely filed petition for redetermination of deficiency. IRC § 2014(e).

If the Credit is based on a treaty, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b) (Form 8833) must be attached to the 706, describing the basis under the treaty for claiming the Credit.

The amounts on Schedule P must be shown in U.S. dollars and any supporting documentation for values, such as appraisals of the foreign property, must be in English. Although these requirements may seem obvious for filing a U.S. tax return, these requirements raise practical issues for preparing Schedule P.

Translate to English

If appraisals are being attached to the 706, the appraisals must be in English. Often written in the language of the foreign country in which the property is located, the appraisals will likely require translation into English by someone with the appropriate level of expertise. This may be difficult to find and expensive. In addition, the client may need appraisals for adopting the alternate valuation on the 706, which will require further time and expense.

Convert to U.S. Dollars

Similar to the appraisals being prepared in a foreign language, the values will likely be in a foreign currency, which must be shown in U.S. dollars on Schedule P. Treas. Reg. § 20.2014-2(a). Different conversion dates should be used for the two limitation formulas of the Credit calculated on Schedule P.

Because the first limitation formula is based on the foreign death tax, the rate of conversion for the value of the foreign property should be the effective rate on the date that the foreign property is valued for foreign death tax purposes, and the rate of conversion for the amount of foreign taxes paid should be the effective rate on the date that each of the foreign death taxes is paid. Treas. Reg. § 20.2014-2(b);

Rev. Rul. 75-439, 1975-2 C.B. 359. As the second limitation formula is based on the U.S. estate tax, the rate of the conversion should be the effective rate on the date of the decedent's death or the alternate valuation date, whichever is used for estate tax purposes. Treas. Reg. § 20.2014-3(a).

The rate of conversion may be any commercially acceptable conversion rate, typically published by banks or in business newspapers. Because the Department of the Treasury publishes quarterly rates of exchange to be used by all U.S. governmental agencies, these rates should be the most reliable for reporting on the 706. The Treasury's published rates can be found on the Internet at www.fms.treas.gov/intn.html, along with information for obtaining historical exchange rates not published on that web page.

Certificate of Payment of Foreign Death Tax

The instructions for Schedule P require that payment of the foreign death taxes be evidenced by attaching the 706-CE to the 706. Because proof of payment is required to obtain the Credit, the most essential part of obtaining the Credit, after paying the foreign death taxes, is filing the 706-CE. For this essential step, local counsel should serve to facilitate the filing of the 706-CE.

First, the 706-CE should be prepared in accordance with its instructions, of which a few are noteworthy. Similar to Schedule P, a 706-CE should be prepared for each separate taxing authority to which foreign death taxes were paid. Unlike Schedule P, the values shown on the 706-CE must be in the foreign currency.

The instructions state that three of each 706-CE should be prepared: the original form, one copy for the foreign taxing authorities, and one for the records of the decedent's estate. The foreign taxing authorities need to send one copy to the IRS and keep one copy for their own records. Pursuant to the instruction for Schedule P on the 706, a copy also needs to be filed with the 706. Accordingly, having four copies of each 706-CE seems to make better sense: two for the foreign taxing authorities, one for the records of the decedent's estate, and one to attach to the 706.

Next, the 706-CEs need to be certified by the foreign taxing authorities responsible for collecting the foreign death taxes for which the Credit is being claimed. After certification, the foreign tax authorities should file the 706-CEs with the IRS pursuant to the instructions on the 706-CE. Local counsel will be helpful for following up with the taxing authorities to ensure that the documents are certified and sent to the IRS.

If the foreign government fails to certify the 706-CEs, the Credit may still be obtained. As described above, the 706-CEs must be filed with the IRS with the foreign death tax return and the tax receipts or cancelled checks showing the payment of the foreign death taxes to the foreign tax authorities. As already noted, any documents in a foreign language should be translated into English. In addition, a statement must be filed under penalties of perjury explaining why the foreign taxing authorities would not certify the 706-CEs.

Conclusion

Despite diligently following the requirements for the Credit, the filing may fail to qualify for the Credit. In that case, the estate may claim a deduction for the foreign taxes paid as a claim against the decedent's estate. See IRC § 2053(a)(3). Although the deduction is less valuable than the Credit, the deduction is a backup to the Credit. n