

Estate and Inheritance Tax Rules in the United States and Spain

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There is an increasing amount of motivations to acquire properties abroad, including investing, creating a vacation refuge, or job placement. Acquiring and maintaining property abroad brings with it several administrative and tax consequences. Estate and inheritance taxes are often overlooked and can provide a trap for the unwary.

In the United States, estate taxes only affect two percent of all Americans¹, but it does at significant costs to the estate. Good anticipated legal planning might be able to ameliorate the impact of the "death taxes." This article discuss the basics of the U.S. Estate and Gift tax rules, an overview of the Spanish Inheritance Tax Rules, their application to property located abroad, and how citizens, residents and foreign nationals are affected by them.

U.S. Estate Taxes

Estate & Gift Tax Rules

The U.S. generally taxes its citizens on their *worldwide income*, regardless of their country of residence or source of income². Additionally, U.S. citizens pay federal estate tax on their *worldwide assets*, without regard to the location of such assets³. In addition to the federal government, which collects taxes through the Internal Revenue Service (IRS), many states also impose an estate or inheritance tax⁴.

Federal Estate Tax

The federal estate tax is imposed "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States⁵." The United States does not impose federal estate tax on the inheritance of property⁶.

The starting point in the calculation is the "gross estate⁷." Certain deductions (subtractions) from the "gross estate" amount are allowed in arriving at a smaller amount called the "taxable estate."

What is included in the Gross Estate⁸?

The *fair market value* of everything owned plus certain interests is used at the date of death. It includes cash and securities, real estate, insurance, trusts, annuities, business interests and other assets. *See IRS Form 706.*

What is excluded from the Estate⁹?

Generally, the gross estate does not include property owned solely by the decedent's spouse or other individuals. Lifetime gifts that are complete are also excluded.

What deductions are available to reduce the Estate Tax¹⁰?

1. Marital and Charitable Deduction;
2. Mortgages and debt, administration expenses of the estate and losses incurred;
3. Beginning in 2005, inheritance or estate taxes paid to states¹¹.

The value of lifetimes taxable gifts – gifts that exceed the annual exemption amount (13,000 per person) - made after 1976 is added to the net amount computed. The tentative tax is computed according to a table provided¹² by the IRS and is subsequently reduced by the available unified credit. Only taxable estate and lifetime gifts that exceed \$1,500,000 in 2004 - 2005; \$2,000,000 in 2006 - 2008; \$3,500,000 in 2009; and \$1,000,000 in 2011 are not covered by the credit. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repeals the estate tax for decedents dying after December 31, 2009 and before January 1, 2011. It does not repeal the *gift tax* for 2010, although the rate is reduced from 45% to 35% for gifts made in 2010¹³.

State Estate and Inheritance Taxes¹⁴

Under a "Pickup" tax system the state's share of the taxes comes out of what the estate owes to the IRS, so that no tax beyond the amount paid to the federal government is due to most state.

A number of states impose estate taxes on any real estate and personal property owned by a decedent within the state, which is paid by the estate. Other states impose inheritance taxes paid by the recipient. Different tax rates might apply, depending upon who receives the property. A lot of states are trying to phase out their estate tax rules.

For a list of rules per state visit <http://www.bankrate.com/finance/taxes/check-taxes-in-your-state.aspx>

U.S. Estate Tax Rule on Foreign Property and/or Foreign Nationals

Many foreign nationals planning an extended stay in the U.S. often address the *income tax* issues through tax treaties with their home country or tax equalization (companies that send employees abroad often provide equalization packages through compensation)¹⁵. However, the estate tax rules are often overlooked and can provide a trap for the unwary.

The federal government imposes taxes on the estate of any deceased person who is a *resident* of the United States or who *leaves property located within* the United States¹⁶.

1. Residents and Citizens

The estates of *residents and citizens* include all property held throughout the world, but *a federal estate tax credit is allowed*, with limitations, for any tax paid to a foreign country on property located in that country¹⁷. The estate of a foreign national might include assets not accumulated during his stay in the U.S. or which otherwise had no connection with his presence in the U.S.¹⁸.

A resident for estate tax purposes is someone who had a domicile in the U.S. at the time of death. Domiciled is acquired by living in a place for even a brief period, as long as the person had no intention of moving¹⁹.

2. Non-Resident Aliens

The United States also imposes a tax on the gross estates of non-resident aliens with respect to their U.S. situated assets²⁰. The unified credit available is much smaller for non-residents and the tax is imposed on estates larger than \$60,000 (unified credit of

13,000 only). See IRS Form 706NA. The "gross estate" of a non-resident alien decedent is defined as all property located within the United States and includes²¹: real property located within the United States, Treas. Reg. §20.2104-1(a)(1); stock held in United States corporations, §2104(a); debts held from United States obligors, §2104(c); tangible personal property located within the United States Treas. Reg. §20.2104-1(a)(2)²².

Estate tax treaties between the U.S. and other countries provide favourable tax treatment to non-residents by limiting the type of asset considered situated in the U.S. and subject to U.S. estate tax²³. See table below for a list of countries with treaties with the U.S.²⁴.

Otherwise, the credit that might be available depends on the value of U.S. assets compared to total worldwide assets - the greater the percentage of U.S. assets, the higher the tax obligation²⁵.

Country	Separate Estate	Separate Gift	Combined E & G	Other	Signed	Transfers made on or after:	Comments
Australia	No	Yes	No	No	5305	12/14/53	PR-UC
Australia	Yes	No	No	No	5305	01/07/54	old *
Austria	No	No	Yes	No	8206	07/01/83	new *
Belgium	Yes	No	No	No	5405	not yet	old
Canada	No	No	No	1995 Protocol	9503	11/09/95 **	estate tax only
Denmark	No	No	Yes	No	8304	11/07/84	new
Finland	Yes	No	No	No	5203	12/18/52	old
France	No	No	Yes	No	7811	10/01/80	new
Germany	No	No	Yes	No	8012	01/01/79	new (Protocol)
Greece	Yes	No	No	No	5002	12/30/53	old
Ireland	Yes	No	No	No	4909	12/20/51	old
Italy	Yes	No	No	No	5503	10/26/56	old
Japan	No	No	Yes	No	5404	04/01/55	old
Netherlands	Yes	No	No	No	6907	02/03/71	new
Norway	Yes	No	No	No	4906	12/11/51	old
South Africa	Yes	No	No	No	4704	07/15/52	old
Sweden	No	No	Yes	No	8306	09/05/84 (through 12/31/07)	new (terminated 01/01/08)
Switzerland	Yes	No	No	No	5107	09/17/52	old
U.K.	No	No	Yes	No	7810	11/11/79	new

* old or new refers to whether the treaty has the "old" situs rules, or the "new" provisions that generally restrict the U.S. to taxing nonresident aliens' U.S. real estate and business property.

** the 1995 Protocol had retroactive effect to TAMRA. Claims for refund based upon the treaty had to be filed by 11/09/96.

"PR-UC" in comments section above refers to a pro-rata unified credit provision. (The pro-rata unified credit provisions in the German and French treaties apply only to estate tax, not to gift tax.)

Additionally, the marital deduction is not available to a decedent whose spouse is not a U.S. citizen²⁶. Thus, the estate may be subject to substantial transfer taxes, despite the fact that the assets pass to the surviving spouse.

Credit for Tax on Overseas Inheritance

A credit on the taxes of a citizen's domestic return is allowed for the amount of inheritance taxes paid to another country when the heir resided in a foreign country. *See IRS Form 706-CE*²⁷.

Germany, Japan and Spain are examples of countries in which the beneficiary who receives a gift or bequest - not the deceased's estate - is taxed on its value²⁸.

No Estate Tax on Overseas Inheritances

Even though the estate of a U.S. resident is subject to taxes on all worldwide assets, the IRS does not impose a federal estate tax on *inheritances received* from overseas, a practice that is followed by most all states. *See informational return IRS Form 3520*²⁹.

Estate Tax Planning in the U.S.

1. Sell property with unrealized gain after death: heirs receive a step-up in cost basis to date of death fair *market value*, which generates a smaller gain upon sale³⁰. This provision may not be available after 2010, unless restored by Congress.
2. Charitable Transfers: Lifetime charitable transfers or gifts to charities upon death can reduce the size of the estate and thereby reduce estate taxes.
3. Marital Transfers: neither lifetime gifts nor bequests at death to one's spouse (U.S. citizen) are subject to estate taxes. This is only a deferral tool.
4. Lifetime Gifts to Children/Grandchildren: Each person can make exempt annual gifts of \$13,000 (\$26,000 for husband and wife) to any number of persons.
5. AB Trusts and QTIP Trusts: Designed to make sure the unified credit of each spouse is used to the full extent possible or to permit a spouse to transfer assets to his/her trust while still maintaining control over its disposition.
6. Irrevocable Life Insurance Trusts: Life insurance proceeds are generally not taxable. Estate can be reduced by transfers to a trust³¹.
7. Family Limited Partnership: Allows families to transfer ownership of family-owned closely held businesses to the next generation.

Spanish Inheritance Taxes

The Spanish Inheritance Tax Laws differ greatly to the inheritance laws of the United States, and the U.K. Additionally, lack of proper legal planning, has subjected heirs to double taxation in Spain and in other countries, such as Germany.

Spain's inheritance tax system (ISD), just like the American equivalent, is very complex. Besides the national inheritance tax rules³², all of the 17 autonomous regions can apply their own enacted laws (i.e. allowance, etc). Many regional communities have reduced the ISD, almost

suppressing it (Madrid, Basque Country, Navarre, Valencia, Balearic and Canary Islands). Additionally, other regions, such as Andalusia, have been applying their own allowances above the ones given by the Government. In Andalusia, for example, only 3% of inheritances from parents to children were taxed in 2008³³. So for most small and medium sized inheritances there will be very little to no taxes due. But if the inheritance is larger, or if it is received by non-relatives or wealthy people, the situation becomes more complicated and expensive.

Anticipated legal planning can avoid taxes that could end up leaving the heir with less than 50% of the original estate (due to multiplication coefficients), an amount that can be further reduced by any two countries double taxation impact.

Overview

- Who pays ISD under Spanish law?
 - A resident heir is liable for ISD on the worldwide assets (a resident in Spain is someone who has lived there for at least 183 days of the year).
 - A non-resident heir is liable for assets held in Spain only.
- In Spain, the inheritance or gift tax is paid by the recipients, as opposed to the estate in the U.S. and UK.
- There are no exemptions in Spain (unless property is held by a company), unlike in the U.S. or UK. Spouses are not exempt from Spanish inheritance tax.
- However, there are certain allowances, depending on the degree of kinship (Group 1-4) and the heirs' pre-existing net wealth (For non-residents only Spanish wealth included)³⁴. These allowances are much smaller compared to other countries, like the U.S.

Spanish Inheritance Tax Rule on Foreign Property and/or Foreign Nationals

In general, there are three effective ways of avoiding or minimizing double taxation in the same set of assets that are present in different countries and/or that are held/inherited by residents or non-residents. Keep in mind that even when credits or deductions are allowed, they might not be beneficial when a resident is not subject to a particular tax in their home country or when the taxes paid abroad exceed the amount allowed as a foreign tax credit by the tax authorities.

1. Unilateral deduction allowed by Spanish law: ISD Art 23 provides a deduction for "similar taxes paid abroad" to those resident in Spain. The lesser of two sums may be deducted from the Spanish tax: a) the amount of foreign tax paid or b) the result of applying the average rate of ISD on the gift/inheritance in question to those foreign assets on which foreign tax has been paid³⁵.
2. Reciprocal unilateral deduction/credits allowed by other countries: Most other countries also have rules allowing a deduction or credit against foreign taxes paid in Spain. The United States and the UK are examples.

3. International treaties with Spain: Spain only has international tax treaties with France, Greece and Sweden³⁶. Currently, there is a European Union proposal to make uniform the rules relating to international succession matters between the Member States (2009/0157 COD). Despite enabling greater efficiency in estate planning, it will not resolve the taxation issues faced by individuals.

Spain, the UK, and the US

Having property in both Spain and either the U.S. or the UK, or being a resident of them, have often resulted in double taxation- the estate can be taxed in the UK/U.S. (in the case where the decedent is a UK/U.S. resident), and the heir can be taxed in Spain (in the case of property located in Spain, or when the heir is a Spanish resident). Even though there is no double tax treaty with Spain for inheritance tax, in the UK the Inland Revenue grants “unilateral relief” against the UK tax liability of an amount up to the amount paid in Spain³⁷. Something similar is done by the IRS in the U.S.

Spain and Germany

Germany avoids double taxation by imputing the foreign tax on foreign assets. However, certain assets do not fall under the definition of foreign assets from the German tax perspective, and an imputation credit might not be granted (i.e. foreign bank deposit). According to German tax law, certain assets in Spain constitute domestic assets subject to Germany’s taxing right, prevailing over any taxing right of Spain. Vice versa, Spain might levy (Spanish) inheritance tax on the assets as it qualifies them as taxable domestic assets from their perspective. The European Court of Justice (ECJ) held on February 2009, that double taxation does not itself constitute a breach of the principle of the *free movement of capital* as described by the EC Treaty. It expressly stated that the Member State are not obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to eliminate the double taxation arising from the exercise in parallel of the Member States’ own fiscal sovereignty³⁸.

Inheritance Tax Planning in Spain

There are fewer opportunities to avoid paying excessive inheritance taxes in Spain. The following are some of the vehicles used to do so. They are not our specific recommendation and are applicable only under very specific conditions, which involve legal and financial complexities best worked out with the help of a financial advisor or lawyer specializing in this area.

- Buy property jointly with future inheritors, avoiding taxation in proportion to the ownership share.
- Sell the property to future inheritors. There would be a 7% transfer tax, plus 35% on any capital gain. Advantageous for large estates of non-residents when reinvested abroad.
- Take out a mortgage loan on the property, increasing the liability on the asset. The equity released would have to be reinvested outside of Spain. Used by non-residents.

- Life Interest: transfer the property to an heir and maintain usufructo over it, retaining a lifetime right to use it. This is usually seen as a gift and results in inheritance taxes, albeit at a reduced level depending on the age of persons receiving it.
- Buy or own through a Spanish limited Co.: company shares can be transferred without any transfer tax associated, when less than 50% ownership is transferred and at least one year has passed since incorporation³⁹.

For an effective estate planning, speak with an experienced attorney.

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