



Gains Tax vs. Inheritance Tax

By: Sanford H. Goldberg

As all of our American members are aware, and some of our non-American members may be aware, the U.S. is in the midst of a controversy concerning the elimination of its so-called "federal death tax." The death tax is comprised of the U.S. estate tax and generation skipping tax. It does not apply to the gift tax. The estate tax will decrease until the year 2010 by increasing the annual amount of the exemption and decreasing the rate of tax. In the year 2010, death taxes are eliminated. Because of a quirk in the requirement for reducing the revenues of the U.S. budget, the elimination of the death tax will terminate at the end of 2010 and the existing death taxes will be reinstated. The major argument that is being made in favor of the elimination of the death tax is that it produces little revenue and is a multiple taxation on earnings that have been subject to the income tax during the decedent's life.

In 1971, Canada faced a somewhat similar issue. At that date, Canada was proposing to adopt a capital gains tax at one-half of the personal rates, making capital gains part of the progressive rate system for individuals and taxing gains in the same manner as other income, according to ability to pay. The legislation dropped a proposal of the White Paper to tax accrued gains over five years. As indicated in a paper submitted by the Ministry of Finance to the two Parliamentary committees, two important consequences followed from the decision to eliminate such periodic valuation. The first was the need to tax accrued gains on death to prevent perpetual deferral of tax. Thus, the legislation made gains taxable at death, but also eliminated federal estate and gift taxes. The second was to limit the amount of losses that may be deducted in one year from ordinary income.

Accordingly, with the introduction of an income tax on capital gains in 1972, Canada moved toward a system of taxation on succession and gifts by way of an income tax of incremental increases in value, and as a consequence there are no longer any estate or gift taxes or any succession duties levied by either the federal government or the provinces.

It is interesting to compare the Canadian experience with the experience in the U.K. The U.K. originally had an inheritance tax. It subsequently introduced a capital gains tax, including a deemed realization upon death. As a result, there was multiple taxation of an individual's assets upon his demise. Realizing that this was double taxation on capital, as well as determining the tax basis for the assets, the U.K. reversed its position on the income tax and eliminated the deemed realization provisions.

At this point, the U.S. continued to tax its decedent's under the estate and generation skipping taxes. Canada taxed them under an income tax leading to a conflict in theory when property of a resident of the U.S. was located in Canada and vice versa. Canada has a similar regime. This conflict in the method of taxing taxpayers is important to an individual who moves his place of domicile from one country to another country.

An income tax is due when the individual changes his residence to another country or dies, which might be considered a change of residence. When an individual immigrates into Australia or Canada, his assets are revalued, thus reducing (in the case of appreciated assets) the income tax on death. The tax on emigration may be deferred until death or disposition of the property by posting security. Also, there is no exit tax on property that remains subject to a future Australian or Canadian tax. Thus, upon death, one country may impose an income tax on death while the other country may impose an estate tax. In Estate of Ballard, 85 T.C. 300 (1985), the decedent, a U.S. citizen and domiciliary, died owning real estate in Canada. The estate paid an income tax to Canada on the unrealized appreciation and claimed a credit against its U.S. estate tax. The U.S. Tax Court held that the tax paid to Canada was not an estate tax for which a credit is allowable under IRC '2014(a) and also was not a tax of substantially similar character to the estate tax that was imposed by Canada at the time the United States-Canada Estate Tax Convention was adopted. Therefore the Canadian income tax on death was not creditable.

In this context, you may be interested to note that the German Bundesfinanzhof in a decision dated April 26, 1995 also held that the Canadian capital gains tax could not be credited against the German inheritance tax. See Bundessteuerblatt 199511 540. As there was and still is no German-Canadian Death Tax Treaty, the court had to rely on German domestic law, *i.e.*, on Sec. 21(2) Inheritance Tax Act. It permits a tax credit against the German inheritance tax if the foreign tax levied corresponds to the inheritance tax. In essence, the court concluded that the Canadian capital gains tax did not correspond to the German tax because the Canadian tax was imposed on the capital gain and not on the value of the estate as such.

If the Canadian capital gains tax cannot be credited against the U.S. estate tax or the German inheritance tax, the solution must be by a tax treaty expressly provided for such credit.

The Canadian treaty with the United States and the Canadian treaty with France attempt to coordinate the two different tax regimes. The Canada-U.S. income tax treaty provides for reciprocal concessions by both countries. Canadian residents receive a credit against their income tax for U.S. estate taxes and state inheritance taxes imposed with respect to U.S. situs property and the U.S. grants a credit against its estate tax to its citizens and residents for Canadian and provincial taxes on property located outside of the United States. Art. XXIX.B.6 and 7.

The French treaty provides for reciprocal concessions also. Both Canada and France give a credit for the other's tax. Canada gives its residents a credit against its income tax for French inheritance taxes on property situated in France and France gives its residents a credit against its inheritance tax for the Canadian income tax on Canadian property. Art. 23.

Australia does not have any treaty that deals with this issue.

The new German-Canadian income tax treaty does not deal with this issue.