US Estate Tax for Canadians

As a Canadian you may be unaware that your estate could be impacted by US estate tax if you own US securities or US real estate. This article highlights the potential US estate tax implications that could apply to Canadian estates and suggests a number of planning opportunities to help Canadians minimize these taxes. The strategies discussed in this article apply to individuals who are tax residents of Canada and are not US citizens or taxed as a US person. All amounts are in US dollars.

How Are Canadians Subject to US Estate Tax?

The estate of a Canadian may be subject to US estate tax if the Canadian owned US 'situs' property (US assets) at the time of his or her death, including investments held in registered accounts – such as Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and Tax-Free Savings Accounts (TFSAs). The most common US assets are US real estate (i.e., vacation home) and shares in US corporations. Please see Appendix A for a list of other common types of US property. For example, the estate of a Canadian who dies owning US real estate may be subject to both capital gains tax in Canada due to the Canadian deemed disposition rule, and estate tax in the United States, due to the US estate tax legislation. While in Canada, the deemed disposition of all capital assets immediately before death results in capital gains tax only on the accrued gains on such assets, the US estate tax is imposed on the entire value of the US assets on the date of death.

Do I Have to Worry About US Estate Tax?

If you answer "yes" to both questions below, your estate may be subject to US estate tax:

1. Do you own US assets with a value exceeding $60,000?
2. Will the value of your worldwide assets exceed the lifetime exclusion amount in the year of your death?

The lifetime exclusion amount for 2015 is $5,430,000. Appendix A provides a breakdown of how to determine what constitutes worldwide property and US assets.

Although marital credits are available under the Canada-US Income Tax Treaty (the Treaty) for the transfer of assets at death to spouses, if you are married and you have arranged your affairs as a couple so that all of your combined property will pass to the surviving spouse on the first death, you also need to consider whether the combined value of your property will exceed the lifetime exclusion amount. If so, even if on a first death there may be no US estate tax liability, the estate of the spouse who is the last to die may have a US estate tax liability.

This potential US estate tax liability may be reduced or offset by credits and deductions available under US tax law, and under the Treaty. However, even if no tax is payable, your executor may still be required to file a US estate tax return. Failure to file a US estate tax return can result in a denial of Treaty benefits and credits. In addition, an estate, beneficiary or surviving joint owner may not be able to sell US real property without proof that a US estate tax return has been filed and any tax owing has been paid.

How is US Estate Tax Calculated? Are There Credits Available for Canadians?

US estate tax is calculated in two steps:

Step 1: The value of the taxable estate (i.e., the fair market value of the US assets) is multiplied by the applicable tax rate, as shown in the following chart. The 40% rate applies to taxable estate assets with a value over $1,000,000.

U.S. Estate Tax Rates (in $U.S.)

If the taxable amount is:			Tax rate on excess over (1)
Over (1)	But not over (2)	Tax on (1)	
$0	$10,000	$0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,800	39%
$1,000,000		$345,800	40%

Source: Wolters Kluwer Limited, CCH

Step 2: The amount calculated in Step 1 is then reduced by an estate tax credit called the unified credit. The Internal Revenue Code provides for a minimum unified credit of $13,000. However, the Treaty allows Canadian residents to benefit from the unified credit available to US citizens on the proportion of the value of their US estate assets vis a vis the value of their worldwide assets. The unified credit amount available to US citizens is $2,117,800 in 2015.

For example, if the value of a Canadian resident's US assets represented 20% of the value of his or her worldwide assets, he or she would be entitled to a unified credit of $423,560 (20% of the $2,117,800 unified credit available to US citizens). In this manner, Canadian residents are entitled to a pro-rated unified credit. For 2015, the Treaty protects Canadians who have worldwide assets that do not exceed US $5,430,000.

The Treaty also provides a marital credit if the US assets are left to a surviving spouse. The marital credit is equal to the unified credit (in our example, an additional 20% of the $2,117,800 unified credit available to US citizens would be applied in calculating US estate tax).

Planning Ideas to Reduce US Estate Tax

1. Use professional advisors such as a taxation lawyer or accountant with cross-border expertise.

It is essential to obtain professional advice to assess your potential exposure to US estate tax, and determine what planning opportunities exist that are appropriate to your unique circumstances. Cross-border tax planning involves many complex legal issues including US and Canadian tax law, how they interact, and the application of the Canada-US Tax Convention. Ideally the professional advisor(s) would have both US and Canadian tax expertise and experience dealing with Canada/US crossborder issues.

2. Transfer property from one spouse to another.

A transfer of property between spouses during their lifetime may reduce or eliminate the potential US estate tax on the death of the first spouse by maximizing the pro-rated unified credit and applicable marital credits. This can be combined with a spousal trust (discussed in #3) to further reduce or eliminate the potential US estate tax on the death of the surviving spouse.

In Canada the transfer of property from one spouse to the other generally takes place on a tax-deferred rollover basis. In addition, the income from the property must

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continue to be reported by the same spouse as before the transfer occurred. Gifts to a spouse of US real estate or tangible personal property located in the US may be subject to US gift tax. As such, it will be important to consider these Canadian and US tax implications in any US estate tax strategies involving transfers of property between spouses.

3. Mutual, or, reciprocal spousal trusts to reduce the estate of the surviving spouse.

Each spouse can create a trust for the other in his or her Will. This can reduce or eliminate the US estate tax on the death of the surviving spouse by reducing the value of the US assets and worldwide estate on the second death. The value of property left in a qualifying trust created by a Will for the benefit of the surviving spouse may be subject to US estate tax only once, on the death of the first spouse when the marital credit may be available. To qualify for this special treatment under US law a number of conditions must be met. A review of the terms of the spousal trust in the Will by a US professional is critical to this strategy. The trust may also qualify for the spousal rollover for capital gains tax under Canadian rules.

4. Use of a Qualifying US Domestic Trust

Where property from the estate is transferred to a Qualifying US Domestic Trust, commonly referred to as a QDOT, the US marital deduction is available to eliminate the tax on the death of the first spouse. To qualify as a QDOT, at least one trustee must be a US citizen or a US bank (note that in certain circumstances at least one trustee must be a US bank) and the surviving spouse must be the sole beneficiary during his or her lifetime. Under Canadian income tax rules, a QDOT may also be eligible for the spousal rollover for capital gains tax arising on the death of the first spouse.

This strategy only delays the timing of the US estate tax liability until the death of the surviving spouse. In addition, it exposes the growth in the value of the asset to future estate tax, so in some cases it may be preferable to pay the estate tax on the first death. However, it may be available as a last resort after the death of the first spouse if no other planning has been done. It is possible to build flexibility into the individual's Will to provide for the possibility of a QDOT if it is determined by the executors to be necessary at the time. A review of the terms of the QDOT by a US tax professional is critical to this strategy.

5. Life insurance

Life insurance can be used to fund the US estate tax liability in appropriate circumstances. Life insurance issued on the life of the Canadian individual will not be considered US assets even if the policy is issued by a US entity. In addition, the value of the death benefit can be excluded from the deceased's worldwide property if the deceased did not own the policy. For this reason, it may be worthwhile to consider transferring ownership of the life insurance to a trust or to another person to avoid reducing the available pro-rated unified credit and marital credit.

6. Use a Canadian holding company

The use of a Canadian holding company to own US issued securities will shelter these assets from US estate tax. This is because on the death of the individual shareholder, the company, not the individual, owns the relevant US property. The cost and inconvenience of holding US investments in a holding company must also be balanced against the potential US estate tax savings. Expenses include the cost of incorporation, and the ongoing legal, accounting and other expenses required to implement this strategy and maintain the company. The rate of tax on foreign source income earned through a holding company may be higher than if the foreign investments are held personally, particularly if any foreign withholding tax is applied. In addition, the administration of your estate may become more complex and costly. A holding company is usually wound up in the first year after death in order to prevent the potential double tax that can result from the use of a this structure.

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The transfer of US securities to a Canadian holding company can be affected on a tax deferred basis under Canadian and US rules, although certain tax elections need to be professionally prepared and filed. However, there are US anti-avoidance rules that may permit the IRS, in some cases, to look through corporate ownership where property has been transferred to a holding company. Therefore professional advice should be sought prior to utilizing this planning strategy.

The use of a single purpose Canadian holding company to hold US real estate was a popular planning technique in the past. This was due to a former Canada Revenue Agency (CRA) administrative policy that stated that shareholders of single purpose Canadian holding companies holding US real property would not be assessed taxable benefits in Canada for their personal use of the real estate owned by their corporations. However, as of 2005, the CRA changed its administrative policy, and began to assess such shareholders for the taxable benefits arising from their use of the real property held by their corporations. As a result, the use of a single purpose Canadian holding company to hold US real property is no longer a recommended planning vehicle, although certain single purpose corporations established prior to 2005 may be "grandfathered" under CRA's previous administrative policy.

7. Invest in the US market through mutual funds

Statements made by the IRS suggest that US investments held through Canadian mutual funds will not be considered US assets for US estate tax purposes. Therefore, investing in the US market through Canadian mutual funds can be a viable US estate tax planning strategy.

8. US Real Estate – Use of non-recourse mortgage

A non-recourse mortgage on US real property reduces the value of US assets on a dollar for dollar basis. The borrower under a non-recourse mortgage has no personal liability and the lender can only look to the real property to enforce payment. This type of funding may be difficult to obtain from a commercial lender and may result in non-deductible interest charges.

For more information, speak with your BMO financial professional.

Appendix A: Determining Value of US Property and Worldwide Property

Worldwide Property

Worldwide property includes all property passing on death whether inside or outside your estate and includes US property, life insurance, RRSPs, RRIFs, TFSAs and the value of survivor pension benefits. Property held in trust for an individual will be included in worldwide property if the trust is considered a grantor trust under US rules.

Special Rules for Jointly Owned Property

Where property is held jointly without a right of survivorship, each individual owner is deemed to own his or her proportionate share. The entire value of property held jointly with a right of survivorship is included in the property of the deceased. A deduction is available for any contribution by the surviving owners only if proof is filed with the US estate tax return. These rules apply for determining the value of both US property and worldwide property.

US Property

Property that is considered to be located in the US under the US rules (US property) may be subject to US estate tax. This includes:	Property not considered US property includes:
• Real estate located in the US, including condominiums, co-operatives and time shares. • Personal property permanently located in the US (i.e., furnishings, vehicles, boats). • Stocks, mutual fund units and money market units issued by a US entity (including those held in an RRSP, RRIF or TFSA) and options to acquire such stocks or units. There are "look through" rules for trusts that must be considered in any determination of US property. US property owned by an individual through a trust may be also be US property depending upon the terms of the trust. For stocks, mutual fund units, and money market units, it is the identity of the issuer, not the location of the account which determines whether the securities are US property.	• American Depository Receipts (ADR's) as the underlying security is not issued by a US entity. • Securities denominated in US dollars but issued by a non-US entity. • Units issued by a Canadian mutual fund, whether a corporation or trust, even if the fund invests in US property (unless the mutual fund trust states in its US filings that it is to be treated as a trust under US rules). • US bonds and debt obligations where there is no US requirement to withhold tax on the interest paid to a non-resident alien of the US. Generally, this includes publicly traded US bonds issued after July 18, 1984 held by an individual and not used in a trade or business. • US Treasury Bills or US Certificates of Deposit. • US bank chequing and savings accounts so long as they are not effectively connected to US trade or business.

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01/14-2570

January 2015

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