U.S. Estate Tax for Canadians

Income Tax Considerations

As a Canadian you may be unaware that your estate could be impacted by U.S. estate tax if you own U.S. securities or U.S. real estate. This article highlights the potential U.S. 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 U.S. citizens or taxed as a U.S. person. All amounts quoted are in U.S. dollars.

How are Canadians subject to U.S. estate tax?

The estate of a Canadian may be subject to U.S. estate tax if the Canadian owned U.S. "situs" property (U.S. assets) at the time of their 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 U.S. assets are U.S. real estate (i.e., vacation home) and shares in U.S. corporations. Please see Appendix A for a list of other common types of U.S. property. For example, the estate of a Canadian who dies owning U.S. 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 U.S. 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 U.S. estate tax is imposed on the entire value of the U.S. assets on the date of death.

Do I have to worry about U.S. estate tax?

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

1. Do you own U.S. assets with a value exceeding US$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 2023 is US$12,920,000. While this relatively high exclusion amount may eliminate (or reduce) the U.S. estate tax exposure for many estates, it is important to note that the increased exclusion amount is only effective until the end of 2025, when it is scheduled to revert to the inflation adjusted amount of US$5 million.

Although marital[1] credits are available under the Canada-U.S. 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 U.S. estate tax liability, the estate of the spouse who is the last to die may have a U.S. estate tax liability.

This potential U.S. estate tax liability may be reduced or offset by credits and deductions available under U.S. tax law, and under the Treaty. However, even if no tax is payable, your executor may still be required to file a U.S. estate tax return. Failure to file a U.S. 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 U.S. real property without proof that a U.S. estate tax return has been filed and any tax owing has been paid.

How is U.S. estate tax calculated? Are there credits available for Canadians?

U.S. estate tax is calculated in two steps:

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

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

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 US$13,000. However, the Treaty allows Canadian residents to benefit from the unified credit available to U.S. citizens on the proportion of the value of their U.S. estate assets relative to the value of their worldwide assets. The unified credit amount available to U.S. citizens is US$5,113,800 in 2023.

For example, if the value of a Canadian resident's U.S. assets represented 20 per cent of the value of their worldwide assets, they would be entitled to a unified credit of US$1,022,760 (20 per cent of the US$5,113,800 unified credit available to U.S. citizens). In this manner, Canadian residents are entitled to a pro-rated unified credit. For 2023, the Treaty protects Canadians who have worldwide assets that do not exceed US$12,920,000.

The Treaty also provides a marital credit if the U.S. assets are left to a surviving spouse who is a Canadian or U.S. resident. The marital credit is equal to the unified credit (in our example, an additional 20 per cent of the US$5,113,800 unified credit available to U.S. citizens would be applied in calculating U.S. estate tax).

Planning ideas to reduce U.S. 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 U.S. estate tax, and determine the planning opportunities that are appropriate to your unique circumstances. Cross-border tax planning involves many complex legal issues including U.S. and Canadian tax law, how they interact, and the application of the Canada-U.S. Tax Convention. Ideally, the professional advisor(s) would have both U.S. and Canadian tax expertise and experience dealing with Canada/U.S. cross-border issues.

2. Transfer property from one spouse to another
A transfer of property between spouses during their lifetime may reduce or eliminate the potential U.S. 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 planning idea #3) to further reduce or eliminate the potential U.S. 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 continue to be reported by the same spouse as before the transfer occurred. Gifts to a spouse of U.S. real estate or tangible personal property located in the U.S. may be subject to U.S. gift tax. As such, it will be important to consider these Canadian and U.S. tax implications in any U.S. estate tax strategies involving transfers of property between spouses.

3. Use mutual or reciprocal spousal trusts to reduce the estate of the surviving spouse
Each spouse can create a trust for the other in their Will. This can reduce or eliminate the U.S. estate tax on the death of the surviving spouse by reducing the value of the U.S. 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 U.S. 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 U.S. law a number of conditions must be met. A review of the terms of the spousal trust in the Will by a U.S. 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 U.S. Domestic Trust
Where property from the estate is transferred to a Qualifying U.S. Domestic Trust, commonly referred to as a "QDOT," the U.S. 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 U.S. citizen or a U.S. bank (note that in certain circumstances at least one trustee must be a U.S. bank) and the surviving spouse must be the sole beneficiary during their 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 U.S. 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 U.S. tax professional is critical to this strategy.

5. Life insurance
Life insurance can be used to fund the U.S. estate tax liability in appropriate circumstances. Life insurance issued on the life of the Canadian individual will not be considered U.S. assets even if the policy is issued by a U.S. 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 U.S. issued securities will shelter these assets from U.S. estate tax. This is because on the death of the individual shareholder the company, not the individual, owns the relevant U.S. property. The cost and inconvenience of holding U.S. investments in a holding company must also be balanced against the potential U.S. 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.

The transfer of U.S. securities to a Canadian holding company can be affected on a tax deferred basis under Canadian and U.S. rules, although certain tax elections need to be professionally prepared and filed. However, there are U.S. anti-avoidance rules that may permit the Internal Revenue Service ("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 U.S. 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 U.S. 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 U.S. real property is no longer a recommended planning vehicle, although certain single purpose corporations established prior to 2005 may be "grandfathered" under the CRA's previous administrative policy.

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

8. U.S. real estate – Use of non-recourse mortgage
A non-recourse mortgage on U.S. real property reduces the value of U.S. 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, please speak with your BMO financial professional for an introduction to a qualified cross-border tax professional.

Appendix A: Determining Value of U.S. Property and Worldwide Property

Worldwide property

Worldwide property includes all property passing on death whether inside or outside your estate and includes U.S. real 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 U.S. rules.

Special rules for jointly owned property

Where property is held jointly without a right of survivorship, each individual owner is deemed to own their 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 U.S. estate tax return. These rules apply for determining the value of both U.S. property and worldwide property.

U.S. Property

Property that is considered to be located in the U.S. under the U.S. rules (U.S. property) may be subject to U.S. estate tax. This includes:	Property not considered U.S. property includes:
• Real estate located in the U.S., including condominiums, co-operatives and time shares; • Personal property permanently located in the U.S. (i.e., furnishings, vehicles, boats); and • Stocks, mutual fund units and money market units issued by a U.S. 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 U.S. property. U.S. property owned by an individual through a trust may also be U.S. 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 U.S. property.	• American Depository Receipts ("ADRs") as the underlying security is not issued by a U.S. entity; • Securities denominated in U.S. dollars but issued by a non-U.S. entity; • Units issued by a Canadian mutual fund, whether a corporation or trust, even if the fund invests in U.S. property (unless the mutual fund trust states in its U.S. filings that it is to be treated as a trust under U.S. rules); • U.S. bonds and debt obligations where there is no U.S. requirement to withhold tax on the interest paid to a non-resident alien of the U.S. Generally, this includes publicly traded U.S. bonds issued after July 18, 1984, and held by an individual and not used in a trade or business; • U.S. Treasury Bills or U.S. Certificates of Deposit; and • U.S. bank chequing and savings accounts so long as they are not effectively connected to U.S. trade or business.

[1] For ease of reference, spouse and common-law partner will be referred to as "spouse" in this article.

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