U.S. Estate Tax For Canadians

Introduction

There is currently great uncertainty as to the status of U.S. estate tax legislation. As a result of the failure of the U.S. federal government to pass legislation in 2009, the U.S. estate tax has been temporarily repealed for the year 2010. If no legislative steps are taken in 2010, the U.S. estate tax will be automatically reinstated in 2011 with reduced exemption levels and therefore more significant potential tax liabilities for both Canadians and Americans.

It is not yet clear what path will be taken by U.S. legislators with respect to the U.S. estate tax. It has been suggested that new U.S. estate tax legislation will be passed in 2010 that will be retroactive to January 1, 2010 (although some commentators question whether this is constitutional). Such legislation may either extend 2009 federal estate tax rates and exemptions to 2010 and onwards, or create a new regime. As a result of this uncertainty, planning with respect to U.S. estate taxes is currently very difficult.

Given this uncertainty, the intention of this article is to highlight the potential U.S. estate taxes that might apply to Canadian estates and to suggest a number of planning opportunities that may be available to minimize such taxes. The discussion applies only to individuals who are residents of Canada and are not U.S. citizens or taxed as U.S. persons - i.e., persons who do not hold a green card. All amounts 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 at the time of his or her death. U.S. situs assets include U.S. real estate and shares in U.S. corporations.

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 estate assets which are located in the U.S., on the date of death. Because the determination of U.S. estate tax takes into account assets which may not be included in the Canadian tax net (e.g. life insurance owned by the deceased), at death there is the potential for a Canadian to owe significant U.S. estate taxes, even after foreign tax credit relief is taken into account.

Do I Have to Worry About U.S. Estate Tax?

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

1. Do you own U.S. situs property with a value exceeding $60,000?
2. Will the value of your worldwide assets exceed the applicable exclusion amount in the year of your death?

Note that in 2009, the exclusion amount was $3,500,000. In 2010, there is no U.S. estate tax and therefore no exclusion amount. In the year 2011, if no new U.S. estate tax legislation is passed, the exclusion amount will be reduced to $1,000,000. Although legislation may be passed to extend the 2009 exclusion amount for 2011 and beyond, this is not yet a certainty. Therefore, if your worldwide assets exceed $1,000,000, there is a potential for U.S. estate tax liability in 2011 that should be considered as part of your estate planning.

Appendix A provides a breakdown of how to determine what constitutes world wide property and U.S. situs property for these purposes.

Although marital credits are available under the Canada-U.S. Tax Treaty for gifts made 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 these exclusion amounts. 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 Canadian and U.S. tax law, and under the Canada-U.S. Tax Convention. However, even if no tax is payable, a U.S. estate tax return may still need to be filed.

Failure to file a U.S. return can result in a denial of treaty benefits and credits. The U.S. Internal Revenue Service (the *IRS*) has a right to request information from Canada Revenue Agency (the *CRA*) to enforce compliance with U.S. tax law. 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 the tax owing, if any, has been paid.

How is U.S. Estate Tax Calculated? Are There Credits Available for Canadians?

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

1. The value of the *taxable estate*, which is the fair market value of all of the property of the deceased on death less certain deductions, including debts, funeral expenses etc. is multiplied by a marginal tax rate, which in 2009 ranged from 18% to 45%.
2. The sum obtained from the foregoing calculation is then reduced by an estate tax credit called the *unified credit* and a tax credit for any state or foreign taxes paid.

The unified credit that was available to U.S. citizens in 2009 sheltered the first $3,500,000 in the taxable estate from U.S. estate taxes. As previously noted, if no new legislation is passed in 2010, the U.S. estate tax will be reinstated in 2011 but the unified credit that will be available to U.S. citizens will be reduced to $1,000,000.

In the absence of an applicable tax treaty, the unified credit that was available for non-residents in 2009 only sheltered $60,000 of taxable estate assets. However, because of provisions in the Canada-U.S. Tax Convention, Canadian residents could also benefit from the unified credit available to U.S. citizens on the proportion of the value of their U.S. estate assets vis a vis the value of their worldwide assets. For example, if the value of a Canadian resident's U.S. assets represented 20% of the value of his or her worldwide assets, he or she would be entitled to 20% of the unified credit available to U.S. citizens. In this manner, Canadian residents are entitled to a *pro-rated unified credit*.

As previously noted, the Canada-U.S. Tax Convention also provides a marital credit if the U.S. situs assets are left to a surviving spouse. The marital credit is equal to the unified credit (in our example, an additional 20% of the unified credit available to U.S. citizens would be applied in calculating U.S. estate tax).

Planning Ideas for 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 what planning opportunities exist 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. Usually a minimum of two professionals are required, one with U.S and one with Canadian tax expertise, and ideally both should have 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 the use of spousal trusts as discussed below to further reduce or eliminate the potential U.S. estate tax on the death of the surviving spouse.

Generally transfers of property from one spouse to the other take place on a rollover basis in Canada and the income from the property must continue to be reported by the same spouse as before the transfer. 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.

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 U.S. estate tax on the death of the surviving spouse by reducing the value of the U.S. situs property and world wide estate on the second death. The value of property left in a qualifying trust created by 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 Domestic Trust - May be done post-mortem

Where property from the estate is transferred to a Qualifying U.S. Domestic Trust, commonly referred to as a “Q-Dot”, the U.S. marital deduction is available to eliminate the tax on the death of the first spouse. To qualify as a Q-Dot, 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 his or her lifetime. Under Canadian income tax rules, a Q-Dot 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. However, it may be available as a last resort after the death of the first spouse if no other planning has been done. As previously noted above, a review of the terms of the Q-Dot by a U.S. 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 U.S. situs property 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 world wide property if the deceased did not own the policy. For this reason, it may be advantageous to transfer 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 company must also be balanced against the potential U.S. estate tax savings. Expenses will include the cost of incorporation, and the 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. 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 holding company.

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 IRS in some cases, to *look through* corporate ownership where property has been transferred to a 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 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, in 2004, 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 of this change in policy, the use of a single purpose Canadian holding company to hold U.S. real property is no longer a viable planning technique.

7. Invest in U.S. market through mutual funds

Recent statements issued by the IRS suggest that U.S. investments held through Canadian mutual funds, will not be considered U.S. situs property 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 a non-recourse mortgage

A non-recourse mortgage on U.S. real property reduces the value of U.S. situs property 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.

9. Wait and see & other planning opportunities

A number of other planning opportunities may be available, depending on the individual's circumstances. One option may be to 'wait and see' how future changes to U.S. estate tax may affect your estate. Given the current uncertainty, and depending on your age, health and potential liability, you may want to adopt a 'wait and see' attitude for the present and monitor the situation over the next few years.

How BMO Nesbitt Burns can help

Your BMO Nesbitt Burns Investment Advisor can discuss your investment objectives and how they may impact your potential exposure to U.S. estate tax. Your Investment Advisor can also introduce you to one of our Estate & Insurance Advisors, and professionals who have expertise in Canada/U.S. cross-border tax and estate planning.

Appendix A: Determining Value of U.S. Property and World Wide Property

World Wide Property

World Wide Property includes all property passing on death whether inside or outside your estate and includes U.S. Property. Life insurance, RRSPs, RRIFs and the value of survivor pension benefits are all included. Special rules regarding jointly held property are discussed below. Property held in trust for an individual will be included in World Wide Property if the trust is considered a grantor trust under U.S. rules.

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:

- 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 and options to acquire such stocks or units.

There are "look through" rules for trusts that need to be considered in any determination of U.S. Property. U.S. Property owned by an individual through a trust may be 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.

Property not considered U.S. Property includes:

- American Depository Receipts (ADR's) 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. However, this may not be the case where the mutual fund trust represents 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 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.

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 U.S. Estate Tax return. These rules apply for determining the value of both U.S. Property and World Wide Property.

11/10 -286