

TAX BULLETIN

U.S. Estate Tax Issues for Canadians

July 2011

CONTENTS

- How the U.S. estate tax applies
- U.S. estate tax changes
- U.S. estate tax rates and exemptions
- Planning in uncertain times
- Summary

To ensure compliance with the U.S. Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the *Internal Revenue Code* or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Death and taxes – two sure things in life. Did you know that even if you're resident in Canada when you die, if you own property in the U.S. – perhaps a vacation home in Florida, a ski chalet in Idaho or U.S. securities – you may be subject to U.S. estate tax?

U.S. estate tax arises on the death of an individual and is applied at graduated rates to the value of the individual's taxable estate. The same rates apply whether the individual is a U.S. citizen, a U.S. resident, or a non-resident – the difference is that for non-residents, only the value of property with a U.S. location or connection is included in calculating the estate that is subject to the tax. Note that in this bulletin reference to a non-resident of the U.S. does not include a U.S. citizen living in Canada.

In this bulletin, we'll consider some of the U.S. estate tax issues that Canadian residents (who are not U.S. citizens) should keep in mind if they own – or are considering buying – U.S. property. Unfortunately, the U.S. estate tax system is currently in a state of flux, which means engaging in tax planning is even more of a challenge than you might expect.

How the U.S. estate tax applies

U.S. estate tax applies differently depending on whether the individual was a U.S. citizen or domicile at the time of their death. When a U.S. citizen dies, U.S. estate tax applies to the fair market value of the world-wide property owned at the date of death. A non-U.S. citizen who is domiciled in the U.S. is also taxed on the value of their world-wide estate at death.

The concept of domicile used for estate tax purposes is different from the concept of residence used for U.S. income tax purposes. For example, a green card holder and an individual resident in the U.S. are U.S. residents for income tax purposes, but not necessarily for estate tax purposes if they have stronger ties to a country other than the U.S. and an intention to return to that other country at the time of death. The determination of domicile is a facts and circumstances determination, and further discussion is beyond the scope of this bulletin. For simplicity, in this bulletin we will refer to U.S. citizens and residents as persons subject to estate tax on a similar basis, and Canadian residents as U.S. non-residents taxed as individuals who are not domiciled in the U.S. at the time of their death.

U.S. estate tax generally applies to property situated in the U.S. that is owned by non-residents of the U.S. In calculating an individual's taxable estate, deductions for debts and certain expenses are permitted. However, for Canadian residents, the permitted deductions are prorated based on the value of their U.S. gross assets over their world-wide assets.

Unlike the U.S., Canada does not have an estate tax. But, when Canadian residents die, they are deemed to dispose of all of their capital property at fair market value, unless the property transfers to a spouse or a spousal trust. As a result, in the year of death, if you are a Canadian resident and you own U.S. real property, for Canadian purposes you may have a large "deemed" capital gain with respect to such property, in addition to a possible U.S. estate tax liability. In some cases, the combination of the Canadian tax and U.S. estate tax liability could end up being a substantial percentage of the value of the property.

U.S. estate tax changes

In June 2001, the U.S. passed a law that gradually increased the effective estate tax exemption and phased out the estate tax over the following decade, concluding with the repeal of estate tax for the 2010 year. However, the 2001 changes were contained in legislation

referred to as a reconciliation act, and consequently, it was necessary to include a "sunset clause" to comply with U.S. law. Ignoring the legalities, what this really meant was that the changes enacted in 2001 would not apply after December 31, 2010 and the repeal of the estate tax would only actually last for one year – 2010. Without further legislation, in 2011 the system was set to revert back to the rules that applied just before the 2001 reconciliation bill was enacted, which meant a maximum tax rate of 55% was to apply along with an exemption equivalent of \$1 million.

However, this changed on December 17, 2010 when President Obama signed into law the *Tax Relief, Unemployment Insurance Authorization and Job Creation Act of 2010*, "the Act". The Act reinstated the estate tax at a maximum tax rate of 35% for 2011 and 2012, and the individual credit amount was increased to an equivalent exemption of \$5 million for U.S. citizens and residents. However, the changes made by the Act to estate tax only apply to 2010, 2011 and 2012. In 2013, again due to a sunset clause in previous legislation, the maximum rate will be increased to 55% and the exemption equivalent will be reduced to \$1 million unless new legislation is enacted. It is difficult to predict whether steps will be taken to extend the 2011 and 2012 rates and exemption equivalent amounts to 2013 and beyond.

U.S. estate tax rates and exemptions

For U.S. estate tax purposes, a "unified credit" is available which effectively exempts a portion of the estate from estate tax. For U.S. citizens and residents, the unified credit is based on an effective exemption amount of \$5 million U.S. for 2011 and 2012 and will decrease to \$1 million U.S. in 2013, as shown in the table below. The top estate tax rate for 2011 and 2012 is 35%.

Other graduated rates remain unchanged.

Year	Effective Exemption (U.S. \$)	Top Estate Tax Rate
2008	2,000,000	45%
2009	3,500,000	45%
2010	See Special considerations for 2010	See Special considerations for 2010
2011	5,000,000	35%
2012	5,000,000	35%
2013 and after	1,000,000	55%

Special considerations for 2010

As discussed above, new legislation was passed in December 2010. This new legislation gives the estates of individuals who died in 2010 the choice to use the rules that apply for 2011 and 2012, or to choose the rules that applied in 2010 under the 2001 law. Although the 2001 law repealed estate tax for 2010, there is a cost to choosing the 2001 law because beneficiaries would receive assets from the estate at a modified carry-over basis for income tax purposes, rather than at fair market value. For a Canadian decedent with U.S. estate tax exposure, the U.S. estate tax may reduce the Canadian tax on death caused by the Canadian deemed disposition rules. As the decision to opt for applying the estate tax instead of the modified carryover basis rules may involve detailed analysis, discuss the options with your BDO advisor if you are responsible for an estate that resulted from a death that arose in 2010.

For 2011 and 2012, the graduated estate tax rates and the unified credit are as follows:

Taxable Estate		Estate Tax	
From (U.S. \$)	To (U.S. \$)	Tax on bottom of range (U.S. \$)	Rate on excess
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	and over	155,800	35%
Unified Credit for 2011 and 2012			\$1,730,800

Estates of non-residents

For U.S. estate tax purposes, non-residents are taxed on the fair market value of their U.S. "situs" property. U.S. situs property is basically property situated in the U.S. and includes, for example:

- real property and tangible personal property situated in the U.S. at death,
- U.S. securities, including those held in a brokerage account in Canada or outside Canada,
- certain U.S. debt obligations,
- U.S. mutual funds including money market funds,
- interests in certain trusts including RRSPs, RRIFs, RESPs or TFSAs if the assets held by that trust have a U.S. situs, and
- any business-related assets owned by a sole proprietor and used in a U.S. business activity that are included in the sole proprietor's gross estate. For

example, these assets might include land, machinery and equipment, patents, accounts receivable and goodwill.

There are several types of property which are exceptions to the U.S. situs rules for estate tax purposes. Some of these exceptions include U.S. bank deposits (not effectively connected with a trade or business in the U.S.), U.S. Treasury securities, the proceeds of life insurance on the life of the decedent, and certain portfolio debt obligations. In addition, Canadian mutual fund holding shares of U.S. corporations are classified as a non-U.S.-situs property, since the interest in such a fund is itself treated as an interest in a “corporation,” despite the entity being established under local law as a “trust.”

Under U.S. domestic tax law, U.S. estate tax is applicable on U.S. situs property owned by non-residents; however non-residents are entitled to a much more limited unified credit of \$13,000 U.S., which basically exempts assets worth \$60,000 U.S. This exemption did not increase as a result of the 2010 estate tax changes.

Treaty relief

Fortunately, the Canada-U.S. tax treaty provides Canadians some relief from U.S. estate tax. As discussed below, the treaty provides for a basic unified credit exemption similar to that available to U.S. citizens and residents.

Unified credit exemption – The treaty allows Canadians to benefit from the same exemption amount that U.S. persons can claim. In 2011, the effective exemption amount is \$5 million U.S. However, Canadians must remember that the exemption is prorated based on the ratio of the value of U.S. situs assets compared with the value of the estate as a whole. Where the prorated exemption is less than \$60,000 U.S., the estate of the deceased can make use of the flat \$60,000 U.S. exemption allowed to non-residents under U.S. domestic law.

Canadians must also keep in mind that the value of Canadian assets and the value of the entire estate are based on the U.S. rules. For example, where an individual holds life insurance, the

value of that insurance is included in the value of the estate for U.S. purposes.

To better understand the application of this unified credit exemption, let’s look at an example. A Canadian who dies in 2011 owns a Florida condominium worth \$1,250,000 U.S. and non-U.S. situs assets worth \$5 million U.S.

In this case, the net U.S. estate tax will be calculated as follows:

Estate Tax on \$1,250,000 U.S.:

Tax on the first \$500,000 U.S.	\$155,800
Tax on balance at 35%	<u>262,500</u>
Total before unified credit	418,300

Less:

Prorated unified credit	
\$1,250,000/\$6,250,000 x \$1,730,800	(346,160)
Net U.S. Estate Tax in 2011	<u>\$ 72,140</u>

As you can see from this example, the Canada-U.S. tax treaty provides partial relief from U.S. estate tax, and provides a much higher relief than the \$13,000 statutory unified credit relief under U.S. domestic law.

Small estate relief – There is another exemption provided under the treaty, although it will not be needed in years that the effective estate tax exemption after application of the treaty is more than \$1.2 million U.S. The small estate rule applies where a Canadian has a world-wide gross estate that does not exceed \$1.2 million U.S. at the time of death. If the Canadian’s estate includes U.S. real property, the small estate relief will not apply to the U.S. real property held directly or indirectly by the decedent (this would include interests in U.S. partnerships or corporations holding real property located in the U.S.).

Foreign tax credit treaty relief – Lastly, the treaty provides further relief as the U.S. estate tax that has to be paid on death may be eligible as a credit against Canadian income tax in the year of death on U.S. source income.

Planning in uncertain times

Despite the exemptions and treaty relief, some individuals will still have a U.S. estate tax liability. In addition, it is difficult to plan when it is expected that there will be further changes to the U.S. estate tax regime within two years. With this uncertainty associated with the future of the estate tax rules, planning becomes more complicated and one will want to use a plan which will not cause other tax problems on an ongoing basis and one that can be easily changed in the future.

Some potential estate planning tools that can be used include:

- *Use a Canadian corporation to hold U.S. investment properties* – If a Canadian corporation holds the U.S. property, there should not be a disposition of the property for estate tax purposes on death. However, it should be noted that you may pay more combined Canadian and U.S. income tax on investment income and on the eventual capital gain by using a corporation. In addition, this strategy is not an effective way to hold personal-use U.S. real property, as this creates a Canadian personal tax cost to the owner of the corporation through the assessment of a benefit. Prior to 2005, the CRA allowed the use of a Canadian corporation to hold personal-use U.S. real property, in what was known as a “sole purpose corporation”, without assessing a benefit to the shareholder. Such arrangements in place prior to 2005 are grandfathered, but the CRA policy does not allow new arrangements entered into after 2004 this favourable treatment.
- *Use a non-recourse mortgage to finance U.S. real estate* – In general, liabilities of an individual will be applied on a pro-rata basis to reduce the value of U.S. situs and non-situs assets. However, if you use a

non-recourse mortgage to finance U.S. real property, that liability will be allocated directly against the value of U.S. real property for estate tax purposes. Under a non-recourse mortgage, the lender has recourse only to the mortgaged property and not to the mortgagor personally, in the event of default.

- *Reduce the value of your Canadian estate* – For some people, an estate liability can arise because the value of the individual’s world-wide estate is much higher than their U.S. estate. This is due to the proration of the treaty exemption and the proration of general liabilities discussed earlier. So, if you can take steps to reduce the value of your total estate, a higher unified credit will be available after the proration. Also, a higher proportion of your general liabilities will be applied against your U.S. situs property if the value of your estate is reduced. Reducing the value of your estate below \$5 million U.S. would eliminate U.S. estate taxes completely for deaths in 2011 and 2012.

Other more sophisticated plans are available such as the use of a trust or partnership to hold U.S. situs property and U.S. Qualified Domestic Trusts (QDOTs). In addition to these tax planning ideas, another solution is to simply purchase life insurance to cover the expected estate tax liability. When using life insurance, one must keep in mind the proration rule for the unified credit, and professional advice on structuring life insurance is recommended.

Summary

As you look to enjoy the benefit of a U.S. investment, whether a vacation home or shares in a U.S. company, the U.S. estate tax rules are an important consideration. And planning can be more complex given the uncertainty over the application of these rules in the future. Your BDO tax advisor can help you develop a plan to minimize your potential liability.

The information in this publication is current as of July 31, 2011

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact BDO Canada LLP to discuss these matters in the context of your particular circumstances. BDO Canada LLP, its partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

BDO Canada LLP, a Canadian limited liability partnership, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms.