



BDO Dunwoody LLP
Chartered Accountants
and Advisors

Tax Bulletin

Contents

- ◆ How the estate tax applies
- ◆ U.S. estate tax changes
- ◆ U.S. estate tax rates and exemptions
- ◆ New U.S. income tax rules after 2009
- ◆ Planning in uncertain times

U.S. Estate Tax Issues for Canadians

To ensure compliance with the U.S. Treasury Department regulations, we 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 or a Green Card holder living in Canada. You can refer to our tax bulletin entitled *Tax Consequences for U.S. Persons in Canada* for information concerning U.S. citizens and Green Card holders.

In this bulletin, we'll consider some of the U.S. estate tax issues that Canadian residents (who are not U.S. citizens or Green Card holders) 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 estate tax applies

U.S. estate tax applies to the fair market value of the world-wide property of a U.S. citizen, a Green Card holder and an individual resident in the U.S. at the time of their death. As well, 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 phases out the estate tax over the next decade. Under the legislation, the estate tax rate is gradually being reduced and the exemption amounts are being increased. Based on the changes made, the estate tax will be repealed for the 2010 year. However, this change may not be permanent.

Unlike Canadian tax law, 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 means is that the changes enacted will not apply after December 31, 2010. So, unless further steps are taken, the repeal of the estate tax will only actually last for one year - 2010. In 2011, the system will revert back to the rules that applied just before the 2001 reconciliation bill was enacted. Unfortunately, it is difficult to predict whether further steps will be taken to make this repeal permanent, or to perhaps continue the rules as they apply for 2009.

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 \$2.0 million U.S. for 2008 and will increase to \$3.5 million U.S. in 2009, as shown in the table below. The top estate tax rate is 45% as shown on page 3. Other graduated rates remain unchanged.

Year	Effective Exemption (U.S. \$)	Top Estate Tax Rate
2006	2,000,000	46%
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010	Repealed	Repealed
2011 and after	1,000,000	55%

For 2008, 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	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	and over	555,800	45%
Unified Credit for 2008			\$780,800

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,
- ◆ certain U.S. debt obligations,
- ◆ U.S. mutual funds including money market funds,
- ◆ interests in certain trusts 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.), the proceeds of life insurance on the life of the decedent, and certain portfolio debt obligations.

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 2001 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, Green Card holders, and U.S. residents.

Unified credit exemption – The treaty allows Canadians to benefit from the same exemption amount that U.S. persons can claim. In 2008, the effective exemption amount is \$2.0 million U.S. As with the effective exemption for U.S. residents, U.S. citizens, and Green Card holders, the exemption available under the treaty will increase to \$3.5 million U.S. by 2009. 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 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 is 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, even if the estate is not named as the beneficiary.

To better understand the application of this unified credit exemption, let's look at an example. A Canadian who dies in 2008 owns a Florida condominium worth \$600,000 U.S. and non-U.S. situs assets worth \$2.4 million U.S.

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

Estate Tax on \$600,000 U.S.:	
Tax on the first \$500,000 U.S.	\$155,800
Tax on balance at 37%	<u>37,000</u>
	192,800
Less:	
Prorated unified credit	
\$600,000/\$3,000,000 x \$780,800	<u>156,160</u>
Net U.S. Estate Tax in 2008	<u>\$ 36,640</u>

As you can see from this example, the Canada-U.S. tax treaty only provides partial relief where the value of a Canadian's U.S. property is low in relation to the total value of their estate.

Small estate relief – There is another exemption provided under the treaty, although it will not be needed now that the unified credit exemption has reached \$2.0 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. In this case, the U.S. estate tax will apply only to 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.) and personal property forming part of a permanent establishment or fixed base. So, for example, where this rule applies, shares of a U.S. corporation held by a Canadian will not be subject to U.S. estate tax. This rule was relevant for 2003 and prior years, as the unified credit exemption was less than the \$1.2 million U.S. threshold for the small estate rule.

Additional treaty relief – Another relieving provision under the treaty includes a non-refundable spousal credit exemption. 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.

New U.S. income tax rules after 2009

Under current U.S. tax rules, where an asset is subject to estate tax, the heirs of the deceased generally inherit the asset with a cost base for U.S. income tax purposes equal to fair market value on the date of death. This means that someone who inherits property will only be liable for tax on any appreciation in value that accrues while they own the property – they will not be taxed on any appreciation in value that occurred while the property was owned during the lifetime of the deceased. However, when the estate tax is fully repealed in 2010, this rule will no longer apply.

Though the rules are complicated, for U.S. estate tax purposes *after 2009*, two general rules will apply regarding the cost base of property inherited on death:

- ◆ Where U.S. property of a U.S. resident or citizen is transferred to another U.S. resident or citizen on death, the new owner will assume the property at its original cost for U.S. tax purposes. This rule will also apply to transfers of taxable U.S. property on death between two non-residents of the U.S. So, if a Canadian owns U.S. property and on death (in 2010) that property is transferred to another Canadian, the new owner will assume the property at its original cost for U.S. tax purposes. In recognition that there was an effective exemption for U.S. estate tax purposes, a basic increase is available whereby the tax cost of the deceased's assets can be increased by up to \$1.3 million U.S. where the parties are U.S. persons and by \$60,000 U.S. where the parties are non-residents.
- ◆ Where a U.S. person transfers property on death to a non-resident, the property will be considered disposed of by the deceased at fair market value. So, if a U.S. person dies in 2010 and leaves U.S. property to a Canadian resident (who is not also a U.S. citizen), the Canadian will not end up paying tax on any appreciation in value that occurred during the lifetime of the deceased.

For transfers on death between Canadians, a logical conclusion is that the first rule above would apply on the same basis as the current estate rules. That is, Canadians would also be allowed to increase the basis of U.S. assets by \$1.3 million U.S., except that this basis increase would again be subject to a proration depending on how much of the deceased's estate is made up of U.S. assets. However, it would appear that the current treaty with the U.S. would not allow for this result.

Planning in uncertain times

Despite treaty relief and the increased exemption amounts, some individuals will still have a U.S. estate tax liability. In addition, with the uncertainty associated with the future of the estate tax rules, planning becomes more complicated as the estate tax plan may not be necessary after 2009. So, one will want to use a plan which will not cause other tax problems on an ongoing basis and 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.
- ◆ **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 \$2.0 million U.S. (in 2008) would eliminate U.S. estate taxes completely.

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 the proration rule for the unified credit in mind, and professional advice on structuring life insurance is recommended.

Personal-Use U.S. Real Estate

The decline in value of U.S. real estate and the relative strength of the Canadian dollar compared to the U.S. dollar has recently increased the amount of investment by Canadians in U.S. real estate. Many techniques can be used to plan for potential U.S. estate tax liabilities with the use of trusts to hold the U.S. property being one of the most popular tools used in recent years.

In the past, many Canadians used a Canadian corporation (known as a “single purpose corporation”) to hold personal-use U.S. real estate to avoid U.S. estate tax on the property. Shares of a Canadian company are not U.S.-situs property for U.S. estate tax purposes. As long as the sole purpose of the corporation was to own the U.S. property and all expenses related to the property were paid personally by the shareholders, the Canada Revenue Agency (CRA) would not consider the shareholders to have received a taxable benefit for the personal use of the property. However, using a corporation to hold the property can increase the total tax

on any capital gain realized on the disposition of the property.

If you used a single purpose corporation as a tool to plan for U.S. estate taxes, with the decline in value of U.S. real estate, it might be a good time to reconsider this as a U.S. estate tax planning strategy. The use of “single purpose” corporations is no longer an effective U.S. estate tax planning tool for acquisitions of U.S. real estate after 2004 due to a change in policy by the CRA.

Summary

The 2001 changes and their uncertainty make planning for the estate tax more difficult. We know the U.S. estate tax will be with us for the rest of this decade, but then the uncertainty begins. Despite this, if you own U.S. assets, you should be concerned about the possible application of U.S. estate tax. Your BDO tax specialist can help you develop a plan to minimize your potential liability.

For more information, call your local BDO office or contact our National office at:

Telephone: 1-800-805-9544 Fax: (416) 367-3912

Internet: www.bdo.ca e-mail: info@bdo.ca

This bulletin is a publication of BDO Dunwoody LLP on developments in the area of taxation. This material is general in nature and should not be relied upon to replace the requirement for specific professional advice.

The information in this bulletin is current as of May 15, 2008.

© 2008 BDO Dunwoody LLP