

## TAX BULLETIN

# U.S. ESTATE TAX ISSUES FOR CANADIANS

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 U.S. property – 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 fair market 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 of the U.S. – the difference is that for non-residents, only the value of property with a U.S. location or connection is included in calculating the taxable estate that is subject to the tax.

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. All figures in this bulletin are expressed in U.S. dollars.

### How the U.S. estate tax applies

U.S. estate tax applies differently depending on whether the individual was a U.S. citizen or domiciliary at the time of their death. When a U.S. citizen dies, U.S. estate tax applies to the fair market value of the worldwide property owned at the date of death. A non-citizen who is domiciled in the U.S. is also taxed on the value of their worldwide 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 U.S. green card holder and an individual living in the U.S. are generally considered U.S. residents for income tax purposes, but are not necessarily U.S. domiciliaries for estate tax purposes, if they have stronger ties to a country other than the U.S. and an intention at the time of their death to return to that other country.

The determination of one's country of domicile is based on the facts and circumstances in each case, and further discussion is beyond the scope of this bulletin. For simplicity, in this bulletin we will refer to U.S. citizens and U.S. domiciliaries who are subject to estate tax on their worldwide estate as "U.S. residents" and to those who are not U.S. citizens and who are not domiciled in the U.S. at the time of their death as "Canadian residents".

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For Canadian residents, U.S. estate tax generally applies when they die owning certain U.S. property, for example stock in U.S. companies. In calculating an individual's taxable estate, deductions for debts and certain expenses are permitted. For Canadian residents, the deductions that would otherwise be permitted are prorated based on the value of their U.S. assets (before deductions) as a proportion of their total worldwide assets.

Unlike the U.S., Canada does not have an estate tax. However, when Canadian residents die, they are deemed to dispose of their capital property for income tax purposes. The deemed proceeds of disposition are equal to the fair market value of such property, unless the property is transferred to a spouse or a spousal trust as a consequence of death. As a result, in the year of death, if you are a Canadian resident and you own U.S. real property, for Canadian tax 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 income tax on the deemed disposition and U.S. estate tax could add up to a substantial percentage of the value of the property.

## U.S. estate tax history

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act. This Act kept the federal estate tax rate at 40% and maintained the portability provision. It also doubled the exemption amount for estates of decedents dying after December 31, 2017 to \$10,000,000. This exemption amount is indexed for inflation and is \$11,700,000 in 2021. These increases are set to expire on December 31, 2025 and the exemption amounts will revert to the amounts that applied prior to December 22, 2017, adjusted for inflation, unless further steps are taken to extend these provisions or make them permanent.

## Proposed changes under Biden Administration

Since 2000, there has been an increase in the estate tax exemption amount, from \$1 million in 2000 to \$11.7 million in 2021. During his presidential campaign, President Biden proposed the return of the estate tax exemption and rate to 2009 levels, which would result in an estate tax exemption of \$3.5 million, and a highest marginal estate tax rate of 45%. He also proposed the elimination of the gratuitous cost basis step-up at death.

Here is a quick comparison of the current rules and proposed changes:

- Current: "step-up" basis at death; 40% highest rate; US\$11.7 million exemption
- Proposed: carry-over basis at death; 45% highest rate; US\$3.5 million exemption.

As of the date of this publication, no such tax legislation has been formally proposed or enacted, and it is uncertain what tax provisions (if any) may ultimately be included in any legislation passed in the future.

## Current U.S. estate tax rates and exemptions

For U.S. estate tax purposes, a "unified credit" is available which effectively exempts a portion of one's estate from estate tax. For U.S. residents, the unified credit represents the tax on an effective exemption amount of \$11,580,000 for 2020 and \$11,700,000 for 2021. The top estate tax rate for 2020 and 2021 is 40%. Other graduated rates remain unchanged.

| Year | Effective Exemption (U.S. \$)* | Top Estate Tax Rate | Unified Credit |
|------|--------------------------------|---------------------|----------------|
| 2020 | \$11,580,000                   | 40%                 | \$4,577,800    |
| 2021 | \$11,700,000                   | 40%                 | \$4,625,800    |

\*Annually adjusted for inflation

For 2013 and onwards, the graduated estate tax rates 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      | and over     | 345,800                          | 40%            |

**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 and 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;
- interests in U.S. qualified retirement plans or annuities, including different types of IRA accounts and 401(k) plans; 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 trusts holding shares of U.S. corporations are generally classified as 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. Non-residents are entitled to a limited unified credit of \$13,000, which exempts assets worth \$60,000. Foreign estates with U.S. situs property worth \$60,000 or lower are not required to file a U.S. estate tax return.

**Treaty relief**

Fortunately, the Canada - U.S. Income Tax Convention (“the 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. In order to claim benefits under the Treaty, even if no estate tax is due, the executor of the Canadian estate must file Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return: Estate of nonresident not a citizen of the United States*. Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, must accompany Form 706-NA.

The filing deadline for Form 706-NA is 9 months after the date of death unless an extension of time to file was granted (an executor can apply for an automatic 6-month extension of time to file the return).

Executors of estates that filed estate tax returns after July 2015 are also required to file Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent* to report the final estate tax value of property distributed or to be distributed from the estate. A separate Schedule A is required for each beneficiary to list the property distributed or to be distributed to them. The form must be filed no later than the earlier of the date that is 30 days after the date Form 706-NA is required to be filed or the date that is 30 days after the return was filed.

**Unified credit exemption**

The Treaty allows Canadian residents to benefit from the same exemption amount that U.S. residents can claim. In 2021, the effective exemption amount is \$11,700,000. However, Canadian residents 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, the estate of the deceased can make use of the basic \$60,000 exemption allowed to non-residents under U.S. domestic law.

Let's look at an example. An unmarried Canadian who died in 2021 owned a Florida condominium worth \$1,500,000 and non-U.S. situs assets worth \$18,500,000, for a total estate of \$20,000,000.

The net U.S. estate tax will be calculated as follows:

|   |                   |
|---|-------------------|
| Estate tax on \$1,500,000 U.S.:                             |                   |
| Tax on the first \$1,000,000 U.S.                           | \$345,800         |
| Tax on balance at 40%                                       | <u>200,000</u>    |
| Total before unified credit                                 | \$545,800         |
| Less: Prorated unified credit $\$1,500K / \$20,000K \times$ |                   |
| \$4,625,800   | <u>(346,935)</u>  |
| Net U.S. estate tax in 2021                                 | <u>\$ 198,865</u> |

As shown, the Treaty provides greater relief than the \$13,000 unified credit available under U.S. domestic law.

Canadian residents 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, the value of any life insurance policies controlled by the decedent is included in the value of their estate for U.S. purposes, even if their estate is not named as the beneficiary.

**Small estate relief**

There is another exemption provided under the Treaty, although it will not be needed in years where the effective estate tax exemption is more than \$1,200,000. The small estate rule provides an exemption from estate tax where a Canadian resident has a worldwide gross estate that does not exceed \$1,200,000 at the time of death. However, 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.).

**Marital credit relief**

Another relieving provision under the Treaty includes a non-refundable marital credit up to the amount of the unified credit in connection with transfers to the surviving Canadian spouse. An unlimited marital deduction is available for transfers to a U.S. citizen spouse.

**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 on U.S. source income in the year of death.

**Planning Ideas**

Despite the exemptions and Treaty relief, some Canadian residents will still have a U.S. estate tax liability. The current estate tax exemption is not permanent and will expire in 2025. With constantly changing tax laws, planning becomes more complicated. One will want to implement a plan that 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, it should be excluded from the shareholder's U.S. situs assets 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. The Tax Cuts and Jobs Act reduced the top U.S. federal corporate tax rate from 35% to 21%, but there may still be an income tax cost to owning U.S. property through a corporation versus owning the property personally when you take into account Canadian taxes payable by the corporation and on dividends by the shareholder.

Note that during his presidential campaign, President Biden proposed an increase to the U.S. federal corporate tax rate from 21% to 28%.

The benefit of using this structure will depend on your U.S. estate tax exposure and other considerations. Such considerations might include liability protection if you are renting out U.S. real property.

### **Use a non-recourse mortgage to finance U.S. real estate**

In general, liabilities of a Canadian resident 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, in the event of default, the lender has recourse only to the mortgaged property and not to the mortgagor personally.

### **Reduce the value of your Canadian estate**

For some people, an estate liability can arise because the value of the individual's worldwide 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 one's estate below \$11,700,000 would eliminate U.S. estate taxes completely for deaths in 2021.

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 option 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 property**

Prior to 2005, many Canadians used a Canadian corporation (known as a "single purpose corporation") to hold personal-use U.S. real property 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.

Current CRA policy does not allow new arrangements entered into after 2004 this favourable treatment with respect to the assessment of taxable benefits for shareholders' personal use of the property (arrangements in place prior to 2005 are grandfathered).

In addition, as discussed above, using a corporation to hold the property can increase the total tax on any capital gain realized on the disposition of the property, although the tax differential may not be as significant as it once was due to the decrease in the U.S. corporate federal tax rate to 21%.

Furthermore, there may be an additional tax cost to your estate, because of the potential difference between the estate's adjusted cost basis of the corporation's shares compared to the adjusted cost basis to the corporation of the real estate held by the corporation.

The benefit of using this structure will depend on your U.S. estate tax exposure.

### **Rented U.S. real property**

If you are renting your U.S. real property on an either a full-time basis or part-time basis, in addition to U.S. estate tax exposure you will also have U.S. income tax exposure. For further information on U.S. income tax implications of renting out your U.S. real property, contact your BDO advisor, and see the BDO Tax Bulletin [U.S. Tax Issues for Canadians](#).

### **Gift of U.S. securities**

Some people may consider gifting their U.S. assets to family members during their lifetime in order to avoid U.S. estate tax. This strategy may work for U.S. securities, since this type of asset is not considered to be a U.S. situs asset for U.S. gift tax purposes.

On the other hand, gifting a U.S. real property will result in U.S. gift tax, unless the recipient of the gift is a U.S. citizen spouse. In addition, the recipient's cost basis of the property will equal the cost basis of the transferor for U.S. tax purposes, plus a portion of the U.S. estate tax paid, if any.

If a Canadian resident makes a gift to a U.S. citizen spouse, then the gift will qualify for the unlimited marital exemption. If a Canadian resident makes a gift to a non-U.S. citizen spouse, then the gift will qualify for the annual exclusion amount of \$157,000 in 2020 (\$159,000 in 2021). Gifts to someone other than a spouse would only qualify for the annual gift exclusion amount of \$15,000 in 2020 (\$15,000 in 2021) per recipient.

Note that gifting of U.S. assets could result in Canadian tax, especially when the assets are gifted to someone other than a spouse. Any gift tax paid will not qualify for a foreign tax credit in Canada.

## **Summary**

As you look to enjoy the benefit of a U.S. investment, whether a vacation home or shares in a U.S. company, U.S. estate tax rules should be an important consideration.

If you have questions regarding how the U.S. estate tax rules might affect you, please contact our U.S. Tax Practice Leaders in Canada:

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The information in this publication is current as of May 21, 2021.

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