

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 world-wide 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 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 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 to return to that other country at the time of their death.

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 world-wide 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".

For Canadian residents, U.S. estate tax generally applies when they die owning certain U.S. property, including stock in U.S. companies. In calculating an

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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 world-wide 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

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 law 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, unless further steps were taken, 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. This would have meant a return to a maximum tax rate of 55% and a reduction in the effective exemption to \$1,000,000.

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 U.S. residents with estates of up to \$5,000,000 were effectively exempted from the tax. The Act introduced a portability provision that allowed the unused portion of decedent's unified credit (discussed below) to be applied to the surviving spouse's transfers during life and at death. However, these changes to estate tax only applied to deaths in 2010, 2011 and 2012.

On January 1, 2013, President Obama signed into law the American Taxpayer Relief Act of 2013 (ATRA). ATRA permanently raised the maximum federal estate tax rate to 40% and maintained the \$5,000,000 effective exemption for estates of decedents dying after December 31, 2012. The effective exemption amount has been indexed annually for inflation, starting in 2011. ATRA also made the portability provision permanent.

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 \$5,450,000 for 2016 and \$5,490,000 for 2017. The top estate tax rate for 2016 and 2017 is 40%. Other graduated rates remain unchanged.

Year	Effective Exemption (U.S. \$)*	Top Estate Tax Rate	Unified Credit
2016	\$5,450,000	40%	\$2,125,800
2017	\$5,490,000	40%	\$2,141,800

*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, 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 trusts 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. 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. tax treaty, “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 the 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.

Form 706-NA is due within 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 2016, the effective exemption amount was \$5,450,000. 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 flat \$60,000 exemption allowed to non-residents 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.

Let's look at an example. A Canadian who died in 2016 owned a Florida condominium worth \$1,250,000 and non-U.S. situs assets worth \$5,000,000, for a total estate of \$6,250,000.

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

Estate Tax on \$1,250,000 U.S.:	
Tax on the first \$1,000,000 U.S.	\$345,800
Tax on balance at 40%	<u>100,000</u>
Total before unified credit	\$445,800
Less: Prorated unified credit	
\$1,250K/\$6,250K x \$2,125,800	<u>(425,160)</u>
Net U.S. Estate Tax in 2016	<u>\$ 20,640</u>

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

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 world-wide 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 exemption in connection with transfers to the surviving Canadian spouse. An unlimited marital exemption is available for transfers to U.S. resident 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 in the year of death on U.S. source income.

Planning Ideas

Despite the exemptions and Treaty relief, some Canadian residents will still have a U.S. estate tax liability. With the new administration in the U.S. there are likely to be changes to the estate tax laws. With constantly changing tax laws, planning becomes more complicated. One will want to implement 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, 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.

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 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 one's estate below \$5,490,000 would eliminate U.S. estate taxes completely for deaths in 2017.

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

The decline in value of U.S. real property in recent years has resulted in an increase in the amount of investment by Canadians in U.S. real property. As

noted above, many techniques can be used to plan for potential U.S. estate tax.

In the past, 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.

However, the use of single purpose corporations is no longer an effective U.S. estate tax planning tool for acquisitions of U.S. real property after 2004 due to a change in policy by the CRA with respect to the assessment of taxable benefits for shareholders' personal use of the property. 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. In addition, 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 property, it might be a good time to reconsider this as a U.S. estate tax planning strategy.

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. Your BDO advisor can help you develop a plan to minimize your potential liability.

The information in this publication is current as of April 1, 2017

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