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Canadians & U.S. Estate Tax

Canada does not impose an estate tax on the value of a deceased individual's assets. However, many high -net worth Canadians could find themselves subject to U.S. estate tax on their death if they are not careful; even if they have never set foot in the U.S. This paper will describe how Canadians become liable for U.S. estate tax and how that tax is calculated. It will also provide some helpful strategies that may be available in some situations to reduce U.S. estate tax exposure.

What is estate tax?

Under Canadian tax rules, a deemed disposition will occur for most of an individual's assets at the time of death. That disposition may result in a taxable capital gain for which the estate is liable. U.S. tax rules do not apply a deemed disposition at death, but instead, the U.S. charges an estate tax based on the fair market value of an individual's assets at the time of death. The impact of US estate tax differs, depending on U.S. residency status at the time of death.

U.S. residents

Individuals may be considered residents of the U.S. for estate tax purposes, even if their income is not fully subject to income tax in the U.S. This is because the residency rules are slightly different for estate taxes than they are for income taxes.

Residency for U.S. estate tax purposes is based on your domicile in the year of death. If you are living in the U.S., with the intent to remain permanently, you will have a full estate tax exposure on your worldwide assets in the year of death. Therefore, people living in the U.S. for only a short time may not be taxable on their worldwide income for U.S. income tax purposes, but could still have full U.S. estate tax exposure.

Specifically, the following individuals are considered domiciled in the U.S. for estate tax purposes:

- U.S. citizens, regardless of their current country of residence. Note that a Canadian may be a U.S. citizen under certain circumstances even if little or no time is ever spent in the U.S. This could occur if the Canadian was born in the U.S., or in some circumstances a parent may transmit U.S. citizenship to their child.
- U.S. green card holders, regardless of whether or not they currently live or work in the U.S. A green card holder is considered to be a lawful permanent resident of the U.S. for tax purposes.
- Individual living in the U.S., with the intent to remain permanently. This can include certain visa holders and others.

U.S. estate tax, for U.S. residents, is applied to the fair market value of all worldwide assets owned at the time of death, less various credits and deductions. Unfortunately, there is no deduction given for the cost of the asset, as is the case in Canada when calculating capital gains (and losses) resulting from the deemed disposition of assets at the time of death.

It is interesting to note that, in addition to assets that pass into the estate of a deceased individual, the value of assets that bypass the estate and pass directly to the intended recipient (such as through beneficiary designation or joint tenancy) is also included when calculating estate tax. Commonly held assets which are subject to estate tax include:

- Real estate
- Stocks and bonds
- Insurance on the decedent's life
- Cash

Common deductions that are available to reduce the estate tax liability include:

- Bequests to a surviving U.S. citizen spouse (or to a Qualified Domestic Trust for non-citizen spouses)
- Funeral and estate administration expenses
- Mortgages and liens on property
- Losses during estate administration
- Charitable, public and similar gifts and bequests

The difference between the gross value of the assets that are subject to estate tax and the available deductions is the "Taxable Estate"; the net value that is subject to the estate tax. Once the Taxable Estate is calculated, varying tax rates will apply. Table 1 on the following page provides details regarding the estate tax rates for 2017.

Table 1: 2017 Estate Tax Rates		
Base Tax Before Credits (all figures U.S. dollars)		
Taxable Estate ($)	Estate Tax ($)	Tax on Excess (%)
< $10,000		18%
$10,000	$1,800	20%
$20,000	$3,800	22%
$40,000	$8,200	24%
$60,000	$13,000	26%
$80,000	$18,200	28%
$100,000	$23,800	30%
$150,000	$38,800	32%
$250,000	$70,800	34%
$500,000	$155,800	37%
$750,000	$248,800	39%
$1,000,000	$345,800	40%

For example, an individual with a Taxable Estate of $50,000 will be exposed to U.S. estate tax of $10,600, calculated as $8,200 on the first $40,000 of the taxable estate, plus 24% on the $10,000 excess estate value ($2,400).

However, the good news is that even though the above tax rates indicate an exposure to estate tax, there may not be any actual U.S. estate tax liability. That is because U.S. residents are each entitled to an estate tax credit. The credit, commonly called an exemption, is tied to inflation and, for 2017, is US$5,490,000. In other words, if an individual dies in 2017 and the value of the Taxable Estate is less than $5,490,000, there will not be a U.S. estate tax liability, even though an estate tax return is required to be filed. The $5,490,000 exemption translates into a credit against the estate tax bill of $2,141,800. This is commonly referred to as the "unified credit".

Canadian residents

Canadian residents (who are not U.S. residents for estate tax purposes) unfortunately may be liable for U.S. estate tax at the time of death, depending on the value of their worldwide assets in the year of death as well as the types of assets they hold at that time.

For 2017, deceased Canadians with worldwide assets valued at greater than US$5.49M are generally subject to U.S. estate tax on the total of their "U.S. situs property". The value of the worldwide assets is calculated the same way as it is for U.S. residents. Therefore, the U.S. dollar value of assets owned anywhere in the world, including assets owned in Canada is included. If the total value is greater than US$5.49M, then an estate tax liability will likely arise.

Fortunately, the U.S. estate tax for non-U.S. persons applies only to "U.S. situs property". This includes:

- U.S. real estate including vacation properties, rental properties, private homes or business properties
- Shares of a U.S. corporation (private or public) regardless if the shares were purchased in Canada and held in a Canadian brokerage account
- Debt obligations of U.S. corporations, individuals and governments (except as noted below)
- Personal property located in the U.S. including cars, boats, jewelry and furnishings
- U.S. pension plan amounts and annuities, including IRA's and 401(k)'s
- Interests in partnerships carrying on a U.S. business or holding the above types of property

It is important to note that the above assets are considered U.S. situs property whether they are held personally or in a registered account such as a Canadian RRSP, RRIF, or TFSA.

Not all assets associated with the U.S. are considered to be U.S. situs assets for estate tax purposes. The following are generally excluded from the estate tax calculation for non-residents of the U.S.:

- Canadian mutual funds investing in U.S. equities
- Publicly traded bonds of U.S. corporations and governments
- U.S. T-Bills
- U.S. bank accounts, unless connected with a business
- U.S. life insurance policies
- American depository receipts (ADRs)

Estate taxes are calculated based on the rates described above in Table 1 on the value of the U.S. situs assets owned by the deceased Canadian resident. Fortunately, the Canada-U.S. Tax Treaty provides the estate of deceased Canadian residents with the opportunity to reduce U.S. estate tax in three ways:

1) **Unified Credit** – Under U.S. domestic law, non-residents are entitled to claim a US$13,000 credit against U.S. estate tax. Application of this credit means that no U.S. estate tax liability arises on the first US$60,000 value of U.S. situs assets. However, the Canada – U.S. tax treaty provides even greater relief for Canadians as it allows Canadians to claim the same unified tax credit that is available to U.S. individuals (i.e., $2,141,800). The difference for a Canadian resident is that the unified credit is pro-rated based on the percentage of the total value of U.S. situs assets versus the total value of worldwide assets.
2) **Marital Credit** – The marital credit is a special U.S. credit available to Canadians when a surviving legally married spouse inherits U.S. situs assets at death. The marital credit available to the Canadian spouse is equal to the lesser of the unified credit and the amount of any U.S. estate tax liability after application of the deceased Canadian's unified credit.
3) **Foreign Tax Credit** – U.S. estate taxes paid by the estate of a deceased Canadian resident qualify for a foreign tax credit on the Canadian income tax return for the year of death. The foreign tax credit can be used to offset any Canadian federal income tax liability arising from U.S. source income that would be triggered on the deemed disposition of U.S. assets in Canada. Therefore, even though a U.S. estate tax liability may exist, Canadians may not be exposed to paying additional taxes if the foreign tax credits are fully utilized in the year of death. Generally speaking, Canadian capital gains tax rates are lower than the U.S. estate tax rates and therefore, a U.S. estate tax liability may result.

Example

Adam, a Canadian resident (and not a U.S. resident for estate tax purposes) owns a U.S. stock portfolio worth US$400,000 and a property in Florida with a fair market value of US$600,000. Therefore, his total U.S. situs property is valued at US$1M. The total value of his worldwide assets is US$10M.

As shown in Table 2, if Adam dies in 2017 his gross U.S. estate tax exposure (before any credits) is US$345,800. However, he is entitled to claim a unified credit equal to US$214,180, which is 10% of the total unified credit available (since his U.S. situs property is equal to 10% of his worldwide assets). If Adam leaves his U.S. situs property to his legally married spouse, he will be entitled to an additional marital credit that will eliminate his U.S. estate tax liability. Otherwise, if he does not leave his U.S. property to a legally married spouse, he will be liable for a U.S. estate tax equal to $131,620.

Table 2: 2017 Estate Tax Calculation	
U.S. estate tax (before credits)	$345,800
Less: Unified Credit	($214,180)
Net U.S. Estate Tax	$131,620
Less: Marital Credit	($131,620)
U.S. Estate Tax Liability	Nil

For Illustrative Purposes Only

Tax planning opportunities

To reduce or eliminate a potential U.S. estate tax liability, a Canadian resident should consider the following:

- Use Canadian mutual funds to provide you with U.S. exposure. On January 22, 2010, the IRS ruled that Canadian mutual funds holding U.S. stocks would not be considered US situs assets for US estate tax purposes. As a result of this determination, consider obtaining any U.S. stock market exposure through the use of Canadian mutual funds as opposed to personal ownership of U.S. stocks. This strategy works with either trust or corporate class versions of Canadian funds.
- Keep the value of worldwide assets under $5.49M. This may be accomplished, for example, by giving assets away, including severing joint tenancies respecting Canadian assets. However, caution is needed when gifting U.S. real estate, business properties or tangible property, as there is another U.S. tax, known as a gift tax, that could apply. Canadians are not entitled to a gift exemption and therefore taxable gifts (over and above the annual gift tax exclusion) may create a gift tax liability. To make matters worse, gift taxes do not qualify for foreign tax credits and will result in double taxation. That is, gift tax in the U.S. as well as Canadian income tax that might be triggered on the disposition of assets. Therefore, special care is needed when deciding which assets to gift during your lifetime.
- Leave assets to a legally married spouse in order to benefit from the additional marital credit.

- Hold U.S. situs assets inside a Canadian corporation. If you own U.S. stocks, bonds, or real estate, you may consider transferring them into a Canadian corporation in order to escape estate tax. Since estate tax does not "look through" a Canadian corporation, and since the only asset you'll hold on death is shares of a Canadian corporation (which is not U.S. situs property, even though the corporation itself may hold U.S. situs property), you will not be subject to this tax. Note, however, that Canadian income tax will be applicable to use of U.S. situs real estate by the Canadian shareholder.
- Hold U.S. situs assets through a Canadian resident trust. As the setlor, you can provide the funds to the trust in order to purchase any U.S. situs asset. You cannot be named trustee nor have any control or interest in the trust assets. By structuring the trust properly, you avoid having U.S. estate tax apply upon death. This is generally more common with U.S. real property. The benefit of a trust over a corporation as an ownership structure is that the trust alternative avoids the shareholder benefit that applies when holding U.S. real property in a Canadian corporation. There are however disadvantages to use of a trust for escaping U.S. estate tax. They include; 1) you, as the setlor do not have any ownership rights to the trust assets and 2) the trust assets are subject to the 21 year deemed disposition rule in Canada which deems the assets of the trust to be disposed of every 21 years. This triggers capital gains tax every 21 years in the trust.
- Refinance U.S. situs assets with non-recourse debt. If you own U.S. real estate, consider securing non-recourse debt against the property to get a dollar-for-dollar reduction against the value of U.S. situs assets subject to estate tax. Many U.S., and even some Canadian lending institutions now offer non-recourse debt.
- Hold U.S. and Canadian assets tenants-in-common versus as joint tenants. Where assets are held in joint tenancy, it is presumed that the spouse who dies first contributed 100 percent of the capital necessary to acquire the asset. Therefore, the entire asset value is included in the deceased's owner's estate tax calculation unless the executor can prove that the asset was not acquired entirely with consideration by the deceased. Without sufficient evidence, the asset may be subject to U.S. estate tax twice; once upon death and then again upon death of the surviving joint tenant. Instead of holding assets in joint tenancy, you can hold assets as tenants in common. The basic difference is that a tenant in common does not automatically inherit the interest of the other tenant in common. Therefore, from a U.S. estate tax perspective, there is no presumption that the deceased individual contributed 100 percent of the consideration to purchase the asset and as a result, only the deceased percentage interest in the asset is included in the estate tax calculation.
- Rent, rather than purchase, U.S. situs assets such as vacation properties, boats and autos.

Conclusion

There's no question that without proper planning, U.S. estate tax can take a big chunk out of your estate on death, resulting in less to leave to your heirs. The fact that even non-U.S. residents can be subject to this tax makes planning of utmost importance for anyone with a sizeable net worth. If you have potential estate tax exposure, you should seek the help of a cross-border tax professional, as there are many planning opportunities to reduce your potential liability. In addition, if an intended recipient of your wealth has potential estate tax issues, discuss this with your cross-border specialist as well. There are some special ways to leave assets to these heirs to avoid estate tax in their hands in the future.

Mackenzie Investments Can Help

If you are a Canadian resident with potential exposure to U.S. estate tax, Mackenzie Investments can help meet your tax and investment needs. Mackenzie Investments offer a full range of U.S. investment solutions, including U.S. equity, bond, balanced and money market funds in both trust and tax efficient corporate class structure. Since a Canadian mutual fund holding U.S. equities is not considered U.S. situs property, these funds provide you with the U.S. exposure you desire, but without the added U.S. estate tax issues.

GENERAL INQUIRIES

For all of your general inquiries and account information please call:

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President Trump has proposed significant changes to the US estate tax system but this information is accurate at time of writing June 27, 2017.

Disclaimers to be added:

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

This should not be construed to be legal or tax advice, as each client's situation is different. Please consult your own legal and tax advisor.

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