Reference Guide

US ESTATE TAX

Canadians who die owning "US situs property" – that is, property that is considered to be situated in the US under US rules – may be subject to US estate tax on death.

This reference guide outlines what constitutes US situs property and highlights how and when US federal estate tax may apply, as well as some possible strategies that may be available to minimize US estate tax.

Please note:

- This reference guide is intended for individuals and couples who are Canadian residents, not US citizens or Green Card holders and who have not been US citizens at any time in the preceding 10 years. US citizens, Green Card holders and individuals who were citizens of the US within the past 10 years are subject to very different rules and should consult with qualified cross-border legal and accounting advisors regarding their situation.

- This reference guide deals only with applicable US federal estate tax laws in a general manner. It does not deal with state estate taxes which may also be applicable in certain circumstances.

- For more specific advice relating to your situation, you should consult with qualified cross-border tax professionals.

- All dollar amounts noted in this reference guide are reported in US currency (US$).

What is US Situs Property?

Under the US Internal Revenue Code, US situs property includes the following:

- real estate located in the US

  This would include land, commercial or rental properties, a home or a condominium. Leasehold interests and security interests in real property (e.g. mortgages) may be treated as real property, depending on the circumstances.

- tangible personal property located in the US

  Examples include furniture, vehicles (including a trailer or RV), art and jewellery

- shares of a US corporation

- certain US debt obligations, and

- US mutual funds.

Note that certain assets are considered not to be US situs assets, such as the following:

- cash in a US bank account maintained for personal purposes only (other than cash in a US brokerage account)
- certain exempted portfolio debt obligations
- most government bonds, treasury notes and treasury bills issued by the US government or a US state or political subdivision, and
- proceeds of a life insurance policy, even where payable by a US insurance company.

How US estate tax applies to the estate of a Canadian resident

In Canada, a person who dies is deemed to have disposed of all of his or her capital property at the fair market value of the property just prior to death (unless the property is transferred to a spouse or common-law partner or to a qualifying spousal trust or common-law partner trust). This can give rise to significant capital gains tax payable on death.

The US has a very different method of taxation on death. Instead of taxing capital gains on death, the US imposes an “estate tax” on a deceased individual’s “taxable estate”. The taxable estate is the value of all property in which the deceased individual had an interest, less certain permitted deductions for debts and certain expenses. The taxable estate is taxed at the applicable marginal tax rates for that year. For 2016, these rates range from 18% to a maximum of 40%.

These same rates apply whether the deceased individual was a US citizen, US resident or a non-resident. However, after the tax amount is calculated, a “unified tax credit” is applied against the amount of taxes. The value of the unified credit differs depending on the citizenship and residency status of the deceased individual.

In the case of a US citizen or US resident, the unified tax credit applicable in 2016 can effectively eliminate the estate tax on the first $5,450,000 of taxable estate assets.

For a non-resident of the US, the unified tax credit is not as generous. If there is no tax treaty between the US and the country in which a deceased individual was resident (as there is with Canada, as described below), non-residents of the US who are not US citizens can only apply a unified credit of $13,000, which would exempt assets valued at only $60,000 from US estate tax.

The Canada-US Tax Convention

For deceased Canadians who were non-residents of the US, the Canada-US Tax Convention (the “Treaty”) applies to provide some relief from US estate tax. Under the Treaty, Canadian residents benefit from the same unified tax credit as for US citizens, except that the tax credit is prorated, based on the value of the deceased’s US situs assets compared to the gross value of the deceased's worldwide assets. (Deductions for allowable expenses, such as funeral costs and legal and administration expenses relating to the estate, are also prorated in a similar manner.)

This means that for 2016 for example, Canadians whose worldwide estate is valued at $5,450,000 or less, regardless of the value of the US situs portion, will owe no US estate tax if they use the Treaty credit.

Where the worldwide estate of a deceased Canadian resident is valued at more than $5,450,000, US estate tax may or may not be payable, depending on what proportion of the estate consists of US situs assets.

See, for example, Schedule A which estimates the amount of US estate taxes payable by a Canadian resident with varying amounts of US situs assets and worldwide assets. As shown on the Schedule, a Canadian who owns worldwide assets of $5,450,000 or less on death would pay no US estate taxes, regardless of the value of his or her US situs assets. If the worldwide assets are $7,500,000, there would be no US estate taxes if the US situs assets are worth $200,000, but there would be $2,800 in US estate taxes payable if the US situs assets are worth $300,000. To use the treaty to reduce or eliminate US estate taxes a US estate tax return must be filed within nine months of the date of death.

Valuing assets for purposes of US estate tax

It is important to keep in mind that the value of your assets, for the purposes of US estate tax, is determined in accordance with US rules. This can lead to some unexpected results. For example, unlike the rules in Canada, your estate would include the value of certain property that you transferred in the three-year period prior to your death.

Tax credit in Canada for US estate taxes paid

While Canada allows a tax credit for foreign income tax paid on foreign-source income, this tax credit is not available for US estate tax paid since it is not an income tax. However, some potential tax relief may be available under the Treaty. In particular, to the extent that Canadian federal income taxes are payable on your death as a result of US source income or US situs assets (including a deemed disposition on death), a tax credit is allowed for the amount of US federal or state estate taxes paid. This could offset all or a portion of the Canadian federal income taxes otherwise payable with respect to the US source income or US assets.

In the CRA's view, US estate taxes are not allowed as a foreign tax credit against Canadian provincial taxes arising from the deemed disposition on death.

Minimizing your US estate tax exposure

Depending on your potential US estate tax exposure, there may be some strategies available to minimize US estate tax. However, in considering these strategies, it would be very important to obtain professional cross-border tax and legal advice to ensure that the strategy is appropriate in your situation and that the complexity, costs and risks involved are properly weighed or assessed.

Possible strategies include:

MARITAL CREDIT

One way to minimize your US estate tax exposure is to make use of the marital credit to the extent possible.

For married Canadian couples where neither spouse is a US resident or US citizen, there are two possible ways to take advantage of the marital credit:

1. The use of a qualified domestic trust.

   Using a "qualified domestic trust" for a surviving non-US citizen spouse may be considered as a way to make use of the marital credit. Known as a "QDOT" and created pursuant to US tax rules, such a trust is merely an opportunity to defer US estate taxes, as it is designed to ensure that US estate taxes will ultimately be paid with respect to US assets, either when the trust makes distributions to the non-citizen spouse or when the non-citizen spouse dies.

   A QDOT must meet certain stringent requirements. For example:

   - at least one of the trustees of the trust must be a US citizen or US corporation, and
   - no distribution of capital can be made out of the trust unless the US trustee has the authority to withhold the US estate tax payable on the distribution.

   If a QDOT is created, the marital credit will be available up to the value of the US situs assets passing to the trust for the benefit of the surviving spouse, so little or no US estate taxes would be payable when the first spouse has died.

   If properly structured, a QDOT may also be considered to be a "qualifying spousal trust" for purposes of the Canadian tax rules. This would generally defer the Canadian income tax consequences until the death of the surviving spouse. See our reference guide on spousal trusts for further information.

2. Making an election under the Canada-US tax treaty.

   The Treaty provides another way to take advantage of the marital credit if the deceased and his or her surviving spouse are Canadian residents and non-residents of the US. If the deceased spouse leaves his or her US assets to the surviving spouse, the executor of the estate can elect under the Treaty to claim a marital credit equal to the lesser of:

   - the amount of the unified credit to which the deceased is entitled (either the basic $13,000 credit for non-residents or the Treaty-based credit based on the proportion of US assets to worldwide assets, if higher), or

- the amount of the US estate taxes that would otherwise be payable on the US property transferred to the surviving spouse (with only the above unified credit).

At a minimum, this election would result in a doubling of the basic unified credit to $26,000 for married Canadian non-residents when US situs property is transferred to the surviving spouse on death (but it would not generate a US estate tax refund). However, with the prorated Treaty unified credit, the marital credit could be significantly greater.

To take advantage of the election, the executor must file the election form within nine months after the date of death, and must also waive the right to establish a QDOT within that period of time.

See Schedule B, which estimates the amount of US estate taxes payable on the death of a married Canadian resident with varying amounts of US situs assets and worldwide assets where the US assets are left to a surviving Canadian spouse.

Note that the treaty marital credit is not available to non-married couples, such as common-law partners, and that legal or cross-border tax advice should be considered regarding how the treaty marital credit applies to same-sex spouse situations.

NON-RECOURSE MORTGAGE

If you are a non-resident of the US with a standard mortgage on your US real estate, only a prorated portion can be deducted for US estate tax purposes, even though the full value of the property is included as a US situs asset.

If, however, there is a “non-recourse” mortgage against your US real estate, the entire amount of the mortgage can be deducted from the value of the property for US estate tax purposes. This reduces the value of your US assets subject to US estate tax.

A “non-recourse” mortgage is one in which the lender can only seize the mortgaged property if you default on payments, with no recourse against you personally. (Because of this limitation, such a mortgage can be more difficult to arrange, and a lender will typically charge a higher rate of interest.)

CHARITABLE DONATIONS

Under the Treaty, a deduction is permitted for US estate tax purposes when a Canadian who is a non-resident of the US donates US situs assets on death to a recognized US or Canadian charity. Accordingly, if you are charitably minded, this could be an effective way to reduce your US estate tax liability.

If this is an option you may be considering, you may wish to consider donating US securities to one or more Canadian charities, as this would be beneficial for reducing US estate tax and can also be beneficial for reducing your Canadian taxes on death. This is due to Canadian tax rules that provide a tax advantage for donations of publicly traded securities to Canadian charities (other than private foundations). Following the 2006 Canadian federal budget, no capital gains tax is payable when appreciated publicly traded securities (including stocks, bonds, and mutual fund units) are donated to these Canadian charities. (There is a similar advantage for the donation of securities acquired on the exercise of employee stock options and for the donation of ecologically sensitive land.) As a result of these tax rules, your Canadian personal income tax liability on death can be significantly reduced if you own and donate US securities with accrued gains to one or more qualifying Canadian charities on your death.

OTHER POSSIBLE STRATEGIES

Other possible strategies that might be considered to minimize US estate tax could include:

- **Owning US assets jointly –** In this case, each joint owner must contribute their own funds and be able to trace the source of the funds to the satisfaction of the IRS. Otherwise, the entire value of the jointly owned property will be included in the US estate of a deceased owner.

- **Split interest purchase –** With this strategy, several family members, for example, would acquire an undivided interest in a US residential property. Again, each family member would have to contribute their proportionate share of the purchase price. If only one party (such as a parent) pays the full purchase price, the full value of the property would be subject to US estate tax when he or she dies.

- **Holding US property through a Canadian trust –** Using this strategy, an individual would gift funds to a discretionary trust in an amount necessary to purchase the US property. The trust would then purchase the property. While the individual could not be a beneficiary or trustee of the trust in order to avoid US estate taxes, the spouse and children could be beneficiaries. The individual would have no current or future ownership interest the property and in fact would be required to pay rent to the trust if predeceased by the beneficiary spouse.

- **Holding US assets through a Canadian corporation** - Due to changes in the administrative policy of the Canada Revenue Agency (CRA) effective in 2005, the use of a Canadian single-purpose corporation to hold US personal use real property (such as a house, condominium or other similar property) is not recommended. However, a Canadian corporation could still be considered for US investment assets.

- **Holding US property through a Canadian partnership –** In this case, the partnership would elect to be treated as a corporation for US tax purposes, so that the assets in the partnership would not form part of a partner’s estate for US estate tax purposes. However, it would still be a partnership for Canadian purposes. This avoids some of the issues raised above regarding the use of a Canadian corporation. While this is a complex strategy, it may be worthwhile considering if there are considerable US assets.

Note that the above comments are intended only to provide some general information about possible strategies. As Canadian and US laws are very different in many respects, it is imperative that you consult with qualified cross-border tax advisors to evaluate and determine the most effective strategies that may apply in your situation.

Note also that if you already own a US asset in a way that would trigger US estate tax, it is important to obtain professional tax and legal advice to determine if it is worthwhile to change the ownership method, as changing the ownership method could result in other potential adverse implications.

US gift tax & US generation skipping transfer tax

It is possible that US gift tax and/or US generation skipping transfer tax could apply in certain circumstances. Professional advice should be obtained when you are considering gifting US situs property.

Conclusion

If you are a Canadian who owns US situs property, US estate tax may be payable on your death. However, with proper planning, in consultation with qualified cross-border tax advisors, it is possible that this potential tax liability could be reduced.

There are many complex issues and options to consider when dealing with the interaction of Canadian and US taxation. This is only a very brief overview of one aspect of these issues. We recommend that you obtain advice from qualified cross-border tax advisors to ensure that you optimize your Canadian and US tax situation.

SCHEDULE A

Estimate of US federal estate tax liability (in US$) upon death of a single Canadian resident in 2016.

Value of US Situs Assets (in US $)	Value of Worldwide Assets (in US $)					
	$5,450,000 or less	$5,500,000	$7,500,000	$10,000,000	$15,000,000	$20,000,000
$60,000	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
$100,000	$ 0	$ 0	$ 0	$2,500	$9,600	$10,800
$200,000	$ 0	$ 0	$ 0	$12,300	$26,500	$33,500
$300,000	$ 0	$ 0	$2,800	$24,000	$45,300	$55,900
$500,000	$ 0	$ 0	$14,100	$49,500	$84,900	$102,700
$750,000	$ 0	$ 0	$35,700	$88,900	$142,000	$168,600
$1,000,000	$ 0	$ 0	$62,400	$133,200	$204,100	$239,500
$1,500,000	$ 0	$ 0	$120,600	$226,900	$333,200	$386,400
$2,000,000	$ 0	$ 0	$178,900	$320,600	$462,400	$533,200
$2,500,000	$ 0	$ 0	$237,200	$414,400	$591,500	$680,100
$3,000,000	$ 0	$ 0	$295,500	$508,100	$720,600	$826,900
$3,500,000	$ 0	$ 0	$353,800	$601,800	$849,800	$973,800
$4,000,000	$ 0	$ 0	$412,000	$695,500	$978,900	$1,120,600
$5,000,000	$ 0	$13,300	$528,600	$882,900	$1,237,200	$1,414,400
$6,000,000	n/a	n/a	$645,200	$1,070,300	$1,495,500	$1,708,100
$7,000,000	n/a	n/a	$761,700	$1,257,700	$1,753,800	$2,001,800

SCHEDULE B

Estimate of federal US estate tax liability (in US$) upon death of a married Canadian resident in 2016 leaving US situs assets to spouse (thereby accessing the treaty marital credit).

Value of US Situs Assets left to Surviving Spouse (in US $)	Value of Worldwide Assets (in US $)					
	$10,760,000 or less	$ 10,860,000	$ 11,500,000	$ 12,500,000	$ 15,000,000	$ 20,000,000
$60,000	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
$100,000	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
$200,000	$ 0	$ 0	$ 0	$ 0	$ 0	$12,300
$300,000	$ 0	$ 0	$ 0	$ 0	$2,800	$24,000
$500,000	$ 0	$ 0	$ 0	$ 0	$14,100	$49,500
$750,000	$ 0	$ 0	$ 0	$ 0	$35,700	$88,900
$1,000,000	$ 0	$ 0	$ 0	$5,700	$62,400	$133,200
$1,500,000	$ 0	$ 0	$ 0	$35,600	$120,600	$226,900
$2,000,000	$ 0	$ 0	$6,400	$65,500	$178,900	$320,600
$2,500,000	$ 0	$ 0	$21,500	$95,500	$237,200	$414,400
$3,000,000	$ 0	$ 0	$36,700	$125,400	$295,500	$508,100
$3,500,000	$ 0	$ 0	$51,800	$155,400	$353,800	$601,800
$4,000,000	$ 0	$ 0	$67,000	$185,300	$412,000	$695,500
$5,000,000	$ 0	$ 0	$97,300	$245,200	$528,600	$882,900
$6,000,000	$ 0	$ 0	$127,600	$305,500	$645,200	$1,070,300
$7,000,000	$ 0	$5,400	$157,900	$364,900	$761,700	$1,257,700