U.S. Federal Estate Tax

Note: reference to dollars is in U.S. currency and state estate tax will not be addressed

Legislation passed in December 2010 increased the exemption to $5M for 2011 and to $5,120,000 (inflation-adjusted) for 2012.

The American Taxpayer Relief Act passed on January 1, 2013, increases the top rate to 40% from 35%. Currenty, the exclusion is $5.34M (which is the 2014 inflation-adjusted $5M exclusion). The Act also repeals the 5% surtax on estates over $10M; permanently extends portability of one spouse's unused $5M inflation-adjusted exclusion to the surviving spouse and extends the deduction for State estate tax in arriving at the taxable estate.

Quick Snapshot

1. For 2014, taxable estates at $5.34M or less will not result in U.S. estate tax for U.S. citizens and those domiciled in the U.S. because of the unified credit available to them.
2. Taxable estates at $60K or less will not result in U.S. estate tax for Canadians (non-U.S. citizens).
3. For Canadians, the Canada/U.S. Tax Treaty provides for a marital credit and a proration of the unified credit. If is not eligible to claim the marital credit, a taxable estate greater than $60K could still result in estate tax because the unified credit afforded to U.S. persons is only available to Canadians, on a prorated basis. Even if you were eligible to claim the marital credit, there may still be estate tax, depending on the taxable value of your estate. With the marital credit, or a QDT, you only have deferred the estate tax until the death of the surviving spouse provided the asset is still owned.
4. After 2012, your exposure to estate tax will be greater with a 40% top rate.
5. For Canadian income tax purposes, carryover basis may not be equivalent to the U.S. basis as a result of our deemed disposition rules immediately prior to death. There may be situations where one may not wish make the election not to have estate tax to apply to 2010 in order to deal with the Canadian rules. The Treaty also has some relieving provisions.

General information

The U.S. federal gift and estate tax rules are an integrated system for U.S. citizens and those domiciled in the United States.

Where Canadians are concerned, it should be noted that the Canada\U.S. tax treaty provides some relief to the incidence of federal estate tax. The treaty does not apply to state death tax.

Incidence of estate tax for U.S. persons and those domiciled in the U.S.

The incidence of estate tax is based on a graduated rate system from 18% to 40% applied to your taxable estate. The 18% rate is on the first $10,000 in cumulative taxable transfers and reaches 40% on cumulative taxable transfers over $1M.

For U.S. persons, your taxable estate includes the fair market value of your worldwide assets less deductions for debts and prescribed expenses at death. There is a provision to use an alternate valuation, which is the 6-month value after the date of death or proceeds of disposition received within the 6-month period.

From the initial tax computation, a unified credit of $2,081,800 for 2014 is deducted which is equivalent to a taxable estate value of $5.34M for 2014. A taxable estate less than or equal to $5.34M will not be subject to estate tax. A martial deduction is available for assets transferred from a U.S. decedent to a U.S. citizen spouse which will lower the taxable estate.

Portability has been permanently extended as a result of the January 2013 leglisation. In this regard, an election may be made on a timely filed estate return for the first to die, to transfer the unused unified tax credit of the deceased to the surviving spouse. For example, if $3M of the $5M exemption is needed to reduce the estate tax to nil, then there is $2M available for the surviving spouse's estate. To obtain this benefit, a return for the first spouse must be filed. Executors must remember to file this return especially in cases where the taxable estate for the first spouse in under the annual threshold where a return is not required to be filed. The return is due within 9 months of the date of death or where a filing extension is accepted.

If the surviving spouse is not a U.S. citizen by the time the estate tax return is filed, a deduction is available if property passes to a qualified domestic trust ("QDOT"). The QDOT provides for an estate tax deferral (at the rate in effect when the QDOT was created), until such time as to when the assets are distributed to the surviving spouse or are owned by the QDOT on the death of the surviving spouse.

U.S. estate tax for non-residents

For Canadians, (non-U.S. citizens) only U.S. situs assets such as real estate, tangible property situated in the U.S., stock certificates of U.S. corporations and other assets connected with the conduct of a trade or business situated in the U.S. are included in the gross estate. Only a unified credit of $13,000 equivalent to a taxable estate of $60,000 is allowed. Although not confirmed by the IRS, the unused exemption or unused unified credits attributable to the first spouse to die (as outlined earlier) may be available to the surviving spouse.

Canada\U.S. tax treaty

There are 4 provisions in Article XXIXB of the treaty will that result in an exemption, a reduction, a deferral and a Canadian foreign tax credit for U.S. estate tax for Canadians.

1. A unified credit equal to the greater of $13,000 and the $2,081,800 (2014) unified credit afforded to U.S. citizens, but pro-rated, based on gross the U.S. assets to your total world-wide assets. Certain insurance policies are included in the worldwide estate. Detailed information on the gross worldwide estate must be provided to obtain this credit.
2. The treaty provides for a marital credit up to the prorated unified credit for spousal transfers that would otherwise be available as a marital deduction to a U.S. citizen. Canadian estates, with significant U.S. situs assets that go to the surviving Canadian spouse, may still result in tax payable. If you use a QDOT to defer the tax, the marital credit is not available.
3. If your worldwide gross estate does not exceed $1.2M, estate tax is limited to U.S. situs properties that would otherwise be subject to U.S. income tax under Article XIII (capital gains) such as real property.
4. The treaty also provides for a foreign tax credit on the Canadian terminal/estate returns. This area has certain limitations and is quite complex.

After 2012

As noted above, January 1, 2013 legislation increases the top graduated rate to 40% with an exemption of $5M with an inflation adjustment.Treaty provisions will still apply.

Planning should be considered after 2012 even though the prorated unified and marital credits may currently be sufficient.

Carryover basis

For deaths occurring after 2010, the recipient obtains a basis equivalent to the fair market value at the date of death or six months later if elected. This basis is used to calculate future capital gains on the disposition of inherited property.

Deaths occurring in 2010

For 2010, the December 17, 2010 legislation provides that the "*no estate tax rule"* effective for 2010, will only apply if the executor makes a special election and files an information return IRS Form 8939. On March 31, 2011, the Treasury Department extended the deadline to file the form beyond April 18, 2011 until such time in which regulations are issued. On September 13, 2011, the IRS announced that the deadline for IRS Form 8939 is January 17, 2012.

The legislation provides for a modified carryover basis of property received from a U.S. person who died in 2010 in accordance with IRS Code Section 1022.

The recipient will be entitled to basis equivalent to the lesser of the cost basis to the decedent and the fair market value at the date of death. Under the IRS code, the cost basis to a non-U.S. citizen may be increased to $60K, for others the increase may be up to $1.3M. For transfers to a spouse, the increase may be up to $3M, however this has to be confirmed if it applies to a non-resident alien spouse. These modified increases can not be greater than the fair market value of the property.

If the election is not made or is not timely filed, there will be estate tax for 2010 based on the rules in effect for 2011-2012 with carryover basis equivalent to the fair market value at the date of death or six months later if elected. The September 13, 2011 announcement stated that those who file an extension on Form 4768 will have until March 19, 2012 to file and pay taxes due. Special penalty relief is available to those who already filed an estate return that would be affected by this announcement.

This special election is critical for those who inherited property in 2010 and have already sold the property. For those who sold property in 2010, there is penalty relief available who underestimated the reported capital gain.

Ownership vehicles

For Canadians, there are various ways to hold your U.S. situs property. One should determine the proposed period of ownership and anticipated value at the time of death in conjunction with the costs vs. benefits and the present and/or proposed federal/state legislation. To maximize credits, it may be advisable for one spouse to hold only U.S. situs assets.

In some situations, present ownership of U.S. real estate may be modified, however caution must be taken with respect to both the Canadian and U.S. income tax legislation pertaining to transfer of property, U.S. gift and land transfer taxes.

Corporate ownership

Prior to 2005, it was common to have a single purpose Canadian corporation to hold U.S. situs property because generally there was no incidence of estate tax. After 2004, CRA repealed their administrative position and commenced assessing taxable benefits for personal use of U.S. property owned by a Canadian corporation. With the Treaty provisions and the higher U.S. corporate tax on sale of the U.S. situs property, Canadian corporate ownership is generally not utilized unless where limited liability protection is a major concern. Other options are available to use long-term capital gains treatment and obtain limited liability protection.

On the sale of U.S. real estate or other U.S. situs property, capital gains realized by non-corporate owners attracts long-term capital gain treatment if the property is held over one year. The federal maximum capital gains rate is 20% after 2012 if one is in the 39.6 income tax rate bracket (which is at $400K of taxable income). If one is in the 10%/15% income tax bracket, (generally below $36,900 of taxable income) the long-term rate is 0%. Between the 15% and 39.6 income tax bracket, the maximum long-term capital gains rate is 15% . With corporate ownership, the corporate rate (federal & state) could be as high as 40% which is higher than the Canadian corporate rate.

Joint ownership or tenancy in common

With joint ownership with right of survivorship, property passes to the other joint owners. Only the proportion value of the property based on the amount paid directly by the decedent will be included in their gross estate. If one spouse paid for the property, the entire value will be included in the first and survivor's taxable estate.

A credit is available for federal estate tax paid on prior transfers to the decedent from a person who died within 10 years before or two years after the decedent.

With tenancy in common, you may not escape U.S. state probate, however only the survivor's initial share would be included in their U.S. estate, provided they paid for their initial purchase. A valuation discount may be available at each decedent's death for this form of property ownership. Note that with tenancy in common, each co-tenant is not prevented from selling/gifting the property or placing a mortgage on the property.

Each spouse's Will may provide for a testamentary trust that would leave the share of the U.S. situs assets of the first to die out of the estate of the survivor. This assumes both spouses are Canadians and not U.S. citizens. Complexities arise if one spouse is a U.S. citizen.

Canadian trust

Canadians utilizing an irrevocable discretionary Canadian trust to purchase U.S. property will not escape estate tax if the trust is not created in an appropriate manner. It is important that there is no inference of constructive ownership of the property by the individual funding the purchase.

This ownership vehicle is more complex and is more suited for real estate over the $500K that is not intended to be sold in the short term. If the property is sold, the long-term individual capital gains rates will apply.

Split citizenship

Where one spouse is a U.S. citizen, the composition of assets will determine the liability. If the U.S. citizen spouse dies first, the tax may be significantly lower after applying the treaty marital credit as compared to utilizing a QDOT, and deferring all of the tax (after applying the available unified credit) which would become payable when the surviving spouse encroaches on the capital or dies.

Filing estate tax returns

Estate tax returns (IRS Form 706/706-NA) are due within 9 months of the date of death. For U.S. persons, if the value of your taxable estate is under the annual threshold, no return is required. For non-U.S. persons, the threshold is $60,000.

Contact your professional advisor prior to implementing any of the outlined strategies

Internal Revenue Service Circular 230 Disclosure
Pursuant to Internal Revenue Service Circular 230, we hereby inform you that the advice set forth herein with respect to U.S. federal tax issues was not intended or written to be used, and cannot be used, by you or any taxpayer, for the purpose of avoiding any penalties that may be imposed on you or any other person under the Internal Revenue Code.

Gift Tax

Note: reference to dollars is in U.S. currency and state gift tax will not be addressed

General information

The U.S. federal gift and estate tax rules are an integrated system for U.S. citizens and those domiciled in the United States.

Gifts made by Canadian donors of a present interest in U.S. situs tangible property and real estate are subject to the gift tax based on the above tax rates. In most cases, gifts made by Canadians of intangible property such as shares of a U.S. corporation are not subject to gift tax. Exemptions available to Canadians are significantly lower than what is available to a U.S. citizen or a U.S. domicile.

The Canada\U.S. tax treaty does not provide relief for federal/state gift tax.

Incidence of gift tax

Taxable gifts made during one's lifetime are subject to the same graduated tax rates as estate tax. The 2014, $5.34M lifetime gift tax exclusion/estate tax exclusion is available to U.S. citizens, U.S. domiciliaries and green card holders. Post 1976 taxable gifts are included in the gross estate and credit is given for gift tax previously paid.

For 2014, the first $14,000 of gifts of a present interest annually made by a donor to each donee, are not included as taxable gifts. Gifts above the lifetime exclusion are subject to the 40% maximum rate in accordance with The American Taxpayer Relief Act of January 1, 2013. The determination of the effective tax on taxable gifts made in the current year depends on the taxable gifts made in prior years which could result in a higher effective tax rate on current years' taxable gifts.

With certain exceptions, an unlimited amount of gifts may be made between spouses who are U.S. citizens. With restrictions, an unlimited amount of gifts for a donee's medical and tuition expenses is also available. Gifts to minors in accordance with IRS Code 2503(c) are included in the computation of the annual gift exclusion. A gift tax charitable deduction is also available for gifts to charity.

For 2014, annual gifts of $145,000 made by a U.S. citizen to his/her non-U.S. citizen spouse are not taxable.

Canadians are not eligible to utilize the $5.34M lifetime gift tax exclusion available to U.S. citizens, U.S. domiciliaries and green card holders.

Care should be taken in making non-taxable gifts of appreciated property to spouses and minors as the property transfer and attribution rules in the Canadian Income Tax Act may be costly.

Carryover basis

The donee obtains a basis in gifted property equivalent to the adjusted basis to the donor plus an adjustment for gift tax paid on gift on gifts made after 1976.

Filing gift tax returns

The due date for IRS Form 709 is April 15th, of the year after the gift was made.

You are not required to file Form 709 if (i) you made no gifts during the year to your spouse; (ii) you did not give more than $14,000 (2014) to any one donee, and (iii) all the gifts you made were of present interests.

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