
February 17, 2011

FINANCIAL ADVISORY SUPPORT

# U.S. estate tax for Canadians clarified for 2010 to 2012

## Understand your exposure and strategies to minimize it

*Did you know that if you die owning U.S. assets – such as stock of a U.S. corporation, a yacht in Florida, or a ski chalet in Colorado – you may be subject to U.S. estate tax even though you are not a U.S. resident, citizen or green card holder?*

This article discusses recent changes to U.S. estate tax, determining one's exposure and planning for high net worth Canadians who own or plan to purchase U.S. property. It does not apply to U.S. citizens, green card holders, or residents domiciled in the U.S. For further information pertaining to these individuals please ask your RBC© advisor for the article titled, "Tax and estate planning for U.S. citizens in Canada".

In addition to U.S. federal estate tax, certain U.S. states may levy an estate or inheritance tax. A discussion of U.S. state taxes is beyond the scope of this article. Also, any reference to Canadian tax refers to Canadian tax at the federal level only and does not reflect provincial tax legislation. Canadian provinces may not allow the same treatment as is allowed for federal tax purposes under the Canada-U.S. tax treaty, discussed later in this article. You should consult with a professional cross-border tax advisor regarding the rules for specific U.S. states and Canadian provinces.

## Planning for U.S. estate tax can be complex

You should review your exposure to U.S. estate tax annually to assess the impact of any changes in U.S. estate tax legislation. The information provided in this article with respect to calculating U.S. estate tax is presented in a simplified format. The strategies, guidance and technical content in this publication is intended for the exclusive benefit of our clients and is for information only. This article is not intended to be legal or tax advice. Speak to a professional cross-border advisor specializing in tax and estate planning before acting on any of the strategies discussed in this article to ensure your specific circumstances are taken into account.

## The tax

U.S estate tax is calculated based on graduated rates and applies to the fair market value of your "U.S. situs assets" (i.e., property with a U.S. location or connection, described in further detail later in this article). The same estate tax rates that apply to U.S. citizens will also apply to Canadians. In calculating your tax liability, the U.S. allows deductions for debts and certain expenses, and also has a tax exemption to minimize or potentially eliminate the tax. However, for Canadian residents, the permitted deductions and exemption are prorated based on the value of your gross U.S. assets divided by your worldwide assets.

## Recent changes to U.S. estate tax

Starting in 2002, U.S. estate tax rates were gradually lowered and at the same time the U.S. estate tax exemption gradually increased. Without new legislation, 2010 was to be the year individuals were free of U.S. estate tax. However, on December 17, 2010, U.S. lawmakers signed into law changes to retroactively implement the U.S. estate tax to January 1, 2010 for those who died in calendar 2010. To help counterbalance the re-introduction of estate tax, an optional estate tax system is being made available for deaths occurring in 2010.

**For tax years 2010 to 2012, the new legislation set the top U.S. estate tax rate at 35% (down from the 2009 maximum rate of 45%), with an exemption amount of US $5 million (up from the US $3.5 million exemption for 2009).**

**These changes may reduce or eliminate your exposure to U.S. estate tax since your exemption will now be a prorated percentage of a much higher exemption amount. However, Canadians with significant assets should still manage their U.S. estate tax exposure since these changes only apply to December 31, 2012. After 2012, these changes will expire. Unless further legislation is enacted, in 2013 the top U.S estate tax rate will increase to 55% and the exemption amount will be reduced to only US $1 million.**

Refer to Appendix A for a schedule of the maximum U.S. estate tax rates, exemption amounts and corresponding unified credits for the years 2001 to 2013.

## Optional special election for deaths occurring in 2010

For deaths occurring in calendar year 2010, an executor may make a special election for the estate not to be subject to U.S. estate tax; however, the assets of the estate will be subject to the "modified" carryover basis rules. Under the carryover basis rules, for U.S. federal income tax purposes a Canadian beneficiary who inherits U.S. real property from a Canadian (non-U.S. citizen) decedent will assume the real property at the decedent's **cost basis**. The cost basis is usually the initial purchase price of the property, but may be adjusted up or down for a number of reasons. A basis increase is available whereby the cost basis of the property can be increased by up to US $60,000. However, the rules applicable to property passing to a U.S. citizen spouse are unclear, and as such it is uncertain whether property passing to a surviving U.S. citizen spouse may benefit from a basis increase of up to US $3 million. Executors should confirm with a tax advisor whether the Internal Revenue Services (IRS) has provided further clarity on this issue.

Where the special election is not filed by the executor and U.S. estate tax applies, a beneficiary who inherits real property will have a cost basis for U.S. federal income taxes equal to the fair market value of the property on the decedent's date of death.

Keep in mind, for Canadian income tax purposes there is generally a deemed disposition of real property at fair market value immediately prior to death unless the property is left to a spouse or spousal trust. Consequently, any appreciation on assets transferred to a non-spouse is subject to Canadian capital gains tax in the hands of the decedent. If the special election is made, there may be an element of double taxation for real property that is subject to U.S. income tax when the beneficiary subsequently disposes of it. There is no relief or tax credit available to the beneficiary to reduce U.S. income taxes with the Canadian income taxes previously incurred by the decedent on the property. **Thus, although in 2010 estates may escape U.S. estate tax, the potential capital gains tax liability for decedents (Canadian deemed disposition tax) and their heirs (U.S. income tax) could be even more than what the estate tax would have been.**

Careful consideration will be needed by an executor when contemplating the use of the special election. The executor should consider the needs of each beneficiary as well as the estate as a whole. Important factors to consider include the relative size of the estate and the extent of any accrued gains of the estate assets on death. An executor should seek professional tax advice before making this election.

## U.S. estate tax thresholds

The simplest way to confirm whether your estate will have exposure to U.S. estate tax is to compare the value of your U.S. situs assets and the value of your worldwide estate against the U.S. estate tax thresholds. **If the total value in U.S. dollars of your U.S. situs assets or the gross value in U.S. dollars of your worldwide estate (including Canadian, U.S. and other worldwide assets and certain life insurance policies) is within the thresholds, you will not be subject to U.S. estate tax.**

For deaths during the years 2010 to 2012, the U.S. estate tax thresholds (in U.S. dollars) are as follows:

| | |
|---|---|
| $60,000 | If your U.S. situs assets are US $60,000 or less upon your death, then there is no U.S. estate tax payable regardless of the value of your worldwide assets. |
| $5,000,000 | (a) If your worldwide estate is US $5 million or less upon your death, then there is no U.S. estate tax payable regardless of the value of your U.S. situs assets. |
| | (b) If your worldwide estate is greater than US $5 million upon your death, and the value of your U.S. situs assets is greater than US $60,000, then there may be a U.S. estate tax liability (but not necessarily so). A calculation is required to determine whether a U.S. estate tax liability actually results and the extent of your exposure. Ask your advisor at RBC about using our U.S. estate tax calculator for Canadians to estimate your exposure, if any. |

**Note:** the value of your U.S. situs assets and the gross value of your worldwide estate must be calculated on a per individual basis not per family or per couple.

## U.S. situs assets

The term “value” generally means the fair market value at the date of death, but an alternate acceptable valuation method can be chosen using the fair market value 6 months from the date of death. The valuation method chosen should be used to value all U.S. situs assets as well as property included in your worldwide estate.

Examples of U.S. situs assets located or deemed to be located within the U.S. may include (but are not limited to) the following:

- U.S. real estate
- Assets of a trade or business conducted within the United States (e.g., shares of a U.S. private corporation)
- Shares in publicly traded U.S. corporations, whether held in a brokerage account in Canada or outside Canada or whether purchased on a U.S. exchange or foreign exchange
- Bonds, debentures and other debt obligations issued by U.S. corporations and U.S. governments, unless they are specifically exempted under the portfolio interest exemption (Generally, a portfolio interest exemption means that these U.S. debt obligations were issued after July 18, 1984, and are not subject to U.S. non-resident withholding tax on interest payments)
- Tangible property situated within the U.S. (e.g. vehicles, art, boats, jewellery, etc.)
- U.S. retirement plans (Roth and traditional IRAs; Simple and SEP IRAs; 401(k)s; 403(b)s and annuities)
- Deposits in a U.S. brokerage account (U.S. bank deposits are not U.S. situs)
- Any of the above U.S. securities held in Canadian registered plans such as RRSPs, RRIFs, RESPs, RDSPs or TFSAs
- Any of the above U.S. securities held in discretionary managed accounts (whether held in a brokerage account in Canada or outside Canada or whether purchased on a U.S. exchange or foreign exchange) even though the buy and sell decisions are not made by the individual owner

## Assets not considered to be U.S. situs

Examples of property with U.S. content that may not be considered U.S. situs and thus **may not** be subject to U.S. estate tax include:

- Shares of Canadian mutual fund corporations (i.e., capital class funds) that invest in the U.S. market (even if denominated in U.S. currency);
- Units of Canadian mutual fund trusts (including Exchange Traded Funds (ETFs) trading on the TSX) or another exchange, that invest in the U.S. market. However, this may not be the case where the mutual fund trust represents in its U.S. filings that it is to be treated as a trust under U.S. rules;
- Canadian issued notes that are linked to a U.S. index;
- American depository receipts (ADRs) are exempt from U.S. estate tax because the underlying share is of a non-U.S. corporation;
- U.S. bank chequing or savings deposits so long as they are not effectively connected to U.S. trade or business;
- U.S. Treasury Bills or U.S. Certificates of Deposit;
- U.S. corporate and government bonds subject to the portfolio interest exemption; where there is no U.S. requirement to withhold tax on the interest paid to a non-resident alien of the U.S. and the investments are not used in a trade or business;
- Canadian issuer U.S. pay bonds — providing exposure to the U.S. dollar; and,
- Until December 31, 2011 – U.S. listed ETFs (iShares) that are legally structured as a “Regulated Investment Company (RIC)” may be partially or fully excluded from U.S. situs assets. The portion of the value of the RIC attributable to non-U.S. property is not subject to U.S. estate tax. For example, an iShare structured as an RIC that is fully invested in the European or Asian market would not be a U.S. situs asset. Unless there are further legislative changes, U.S. listed ETFs (iShares) will be considered to be U.S. situs assets starting on January 1, 2012.

## What is included in worldwide estate

Your worldwide estate includes the fair market value of all your assets whether you hold these assets in the U.S. or elsewhere around the world and includes all property listed above as U.S. situs or non-U.S. situs. Some other types of property that you may not be aware must be included in your worldwide estate are:

- the proceeds payable to beneficiaries of any life insurance policy you owned upon your death where you had “incidents of ownership” on the policy – generally meaning you had the ability to: name or change beneficiaries, borrow against the policy, access the cash value or assign or cancel the policy;
- 100% of the value of property you owned as a joint tenant with right of survivorship (JTWROS), unless you can prove that the other joint tenant contributed the capital; and
- property held in trust for an individual if the trust is considered a grantor trust under U.S. tax rules. A grantor trust is a trust in which the settlor retains control over the trust property to the extent that the property's income flows out and is taxed in the hands of that person.

## Calculating U.S. estate tax

<u>Value as of death</u>
U.S. estate tax is calculated differently than Canadian “deemed disposition” tax. For Canadian purposes, tax is payable on an asset only if the fair market value on the date of death is greater than the adjusted cost base of the asset. However, for U.S. estate tax purposes, the cost basis is not netted against the value of the U.S. situs asset on death. The fair market value of the U.S. situs asset on death is used to calculate U.S. estate tax. Therefore, even if an asset you purchased decreased in value, it may still be exposed to U.S. estate tax upon your death.

Allowed deductions
In calculating your taxable estate, the U.S. allows deductions for debts and certain expenses (for example, funeral costs and administrative expenses). The deduction for certain debts and expenses may need to be prorated based on the ratio of U.S. situs assets as a percentage of your worldwide assets. For example, you cannot deduct the full value of a regular mortgage on a U.S. real estate property – only a prorated value is deductible. However, you can deduct the full value of a non-recourse mortgage. Non-recourse mortgages are discussed in greater detail later in the article.

Graduated tax rates for year of death
Once your taxable estate is determined, your tentative U.S. estate tax liability is calculated based on the graduated tax rates in effect in the year of your death. Refer to Appendix B for the graduated U.S. estate tax rates applicable for years 2010 to 2012.

Unified Credit
Your tentative U.S. estate tax liability is reduced by a non-refundable "unified credit" available to you under the Canada-U.S tax treaty. For 2010-2012 the unified credit available to U.S. persons is US $1,730,800 (this is the amount that would offset U.S. estate tax on the first US $5 million of assets using the graduated rate table in Appendix B). However, the unified credit available to Canadians must be prorated. The prorated credit is calculated by taking the ratio of the value of your U.S situs assets less related liabilities (prorated if required) over the value of your worldwide estate. This ratio is then multiplied by the unified credit limit for the year of death to determine how much of the unified credit you can deduct.

Non-refundable unified credit:

$$\frac{\text{U.S situs assets less liabilities (possibly prorated)}}{\text{Value of your worldwide estate}} \times \text{unified credit value for the year of death}$$

Marital credit
If you are leaving U.S. situs assets to a spouse who is resident in Canada or the U.S., the Canada-U.S. tax treaty also allows a non-refundable marital credit to further reduce your tentative U.S. estate tax liability. You must be legally married to someone of the opposite sex. Note: Same-sex partners or spouses do not qualify and common-law partners may also not qualify for this credit.

The marital credit is limited to the lesser of the prorated unified credit discussed above, and the U.S. estate tax otherwise payable on the qualified property that is transferred to a qualified spouse. This in effect "doubles" the unified credit for married Canadians.

Non-refundable marital credit:

Lesser of:

a) non-refundable prorated unified credit; and

b) tax otherwise payable on the qualified property transferred to the spouse.

The availability of this additional credit makes it prudent to provide the executor of your estate some discretion in choosing which assets to transfer to your surviving spouse in order to minimize the U.S. estate tax.

For a numerical example that illustrates a step by step calculation of the U.S. estate tax for Canadians, refer to Appendix C.

## U.S. estate tax calculator

Speak to your advisor at RBC about calculating an estimate of your exposure to U.S. estate tax using the RBC U.S. estate tax calculator. You will need to provide your advisor with the current fair market value of your U.S. situs assets and worldwide estate.

## Claiming foreign tax credits for U.S. estate tax

Under the Canada-U.S. tax treaty, your executor can claim a foreign tax credit on your Canadian final tax return for U.S. estate tax paid. A foreign tax credit will reduce your Canadian tax liability that is attributable to U.S. situs assets reported on your final Canadian return by some or all of your U.S. estate tax liability.

The amount of foreign tax credit you can claim cannot exceed the amount of Canadian income tax attributable to income, profits or gains from any U.S. situs assets reported on your final tax return. It is therefore very important for executors to consider this when making decisions affecting the decedent's final tax return filing. For example, if there are no accrued capital gains on U.S. situs assets or if U.S. assets with accrued capital gains are rolled tax free to the surviving spouse, the decedent's estate may end up paying U.S. estate tax and will not receive an offsetting foreign tax credit because there is no tax owing on your final Canadian tax return attributable to the U.S. situs assets. This may also occur if your RRSP or RRIF containing U.S. property is rolled over to your surviving spouse on a tax-free basis. The foreign tax credit mechanism in effect limits the possibility of double taxation, but it does not limit the possibility of having to pay U.S. estate tax. In the discussion that follows, refer to the section titled, "*Transfer U.S. situs assets to a spouse at FMV at death"* for a detailed discussion regarding triggering Canadian tax attributable to U.S. source income to ensure foreign tax credits for U.S. estate tax can be used.

## Strategies to minimize your U.S. estate tax exposure

Here is a list of common strategies (not an exhaustive list) that you may consider to reduce or eliminate your exposure to U.S. estate tax.  A schedule of common ownership options for Canadians with U.S. real property is provided in Appendix D.

Your specific circumstances will determine the benefit, if any, of one strategy over another or the use of several strategies. Be sure to speak with your own professional cross-border tax or legal advisor regarding which strategy or strategies make sense for you before taking any action.

- Make alternative investment choices

You may want to review your current portfolio and replace some or all of your U.S. situs assets with other investment choices. If you want to be invested in the U.S. market you can choose investments with U.S. content that may not be considered U.S. situs. Refer to the earlier section titled "*Assets not considered U.S. situs*" for examples of investments you might choose from.  Be sure to speak with your tax advisor before implementing this strategy to ensure that your individual circumstances are considered.

- Keep worldwide estate under US $5 million

Provided your worldwide estate at death is US $5 million or less (for deaths in 2010-2012), it is likely that U.S. estate tax is not payable, regardless of how much of your worldwide estate is comprised of U.S. situs assets. As a result, consider rebalancing the ownership of worldwide assets between you and your spouse and/or other family members while you are alive to minimize your worldwide estate at death.  When planning to purchase a new asset, carefully choose who the owner of the new asset should be for purposes of the US $5 million worldwide estate threshold.

With proper estate planning assets you pass to your surviving spouse will not form part of their worldwide estate. For example, you can structure your Will to ensure that assets pass to your surviving spouse through a spousal testamentary trust with limited encroachment on capital. The income earned in the spousal trust must be payable to your surviving spouse; however, distributions of capital should be limited to health, education, support and maintenance. Since your surviving spouse will not have free access to the capital in the spousal trust, upon their death, the spousal trust assets will not form part of your surviving spouse's  estate for U.S. estate tax purposes.

Speak to a qualified tax or legal advisor who can help you consider creditor issues, U.S. gift tax and Canadian deemed disposition and income attribution rules carefully before transferring assets to other family members to reduce your U.S. estate tax exposure. .  Keep in mind that the US $5 million threshold may only exist until 2012.

- Gift U.S. situs assets prior to death

Since U.S. estate tax is determined using the value of U.S. situs assets and the worldwide estate on a per individual basis (not family or couple basis), making gifts may allow for the "rebalancing" of U.S. situs assets between spouses and children in order to minimize or eliminate your U.S. estate tax exposure.

For Canadian residents who are non-U.S. citizens, green card holders or domiciliaries, there is generally no U.S. gift tax when intangible property such as stocks, bonds and cash are transferred to another individual (although, you should be careful of making gifts of cash from U.S. based financial institutions).

However, U.S. gift tax does apply to Canadians when gifts of real estate and other tangible personal property (e.g. vehicles, art, jewellery, etc.) located in the U.S. exceed certain exemption thresholds. If the total value of all gifts of U.S. property to any individual is US $13,000 or less (2010, 2011 threshold) in a given year, these gifts will not attract U.S. gift tax. Where the gift is made to a spouse who is not a U.S. citizen, the threshold for gifts made is US $136,000 for 2011. If you exceed the threshold amounts you will be subject to U.S. gift tax. Unfortunately, Canadians are not able to benefit from the US $5 million lifetime gift tax exclusion available to U.S. citizens, green card holders and US residents domiciled in the U.S.

You must also keep in mind that a gift of an appreciated property to anyone other than a spouse is a disposition at fair market value for Canadian tax purposes, which will trigger unrealized capital gains that are taxable in Canada. Using these exemptions may minimize or eliminate U.S. gift taxes, and any Canadian taxes on capital gains will be deferred on gifts made to a spouse. However, the Canadian attribution rules may apply on any investment income generated on the assets gifted to a spouse or minor children.

- Transfer U.S. situs assets to a spouse at fair market value at death

Due to the ability to claim a foreign tax credit on your final Canadian tax return for U.S. estate tax paid, it would be wise to allow your surviving spouse and executor to elect to transfer certain appreciated U.S. situs assets (non-registered assets) to your surviving spouse at fair market value rather than automatically at cost. This election will trigger U.S. source capital gains on your final Canadian income tax return that can be offset with the foreign tax credit for U.S. estate tax paid. Your surviving spouse will now have a higher adjusted cost base on the U.S. situs assets (non-registered assets) elected to be received at fair market value, which will result in a lower capital gain or higher capital loss when the assets are subsequently disposed of.

Your surviving spouse and executor may also elect not to roll over all the assets in your RRSP or RRIF on a tax free basis. Instead, the fair market value of a portion or all of your RRSP/RRIF assets at the date of death can be reported on your final Canadian tax return. Since this will trigger Canadian tax attributable to RRSP/RRIF income on U.S. assets, you can claim a foreign tax credit for the U.S. estate tax paid. The foreign tax credit allows you to transfer these RRSP/RRIF assets to a non-registered account tax-free. Your executor should also consider the lost tax deferral of income earned in the RRSP/RRIF. Note that in order to execute this strategy, your spouse cannot be named as "successor annuitant" on your RRSP/RRIF. Consider naming your spouse as beneficiary instead.

- Non-recourse mortgage

If you hold a regular mortgage on your U.S. real property only a fraction of the mortgage can be deducted to arrive at your tentative U.S. estate tax. The amount that can be deducted is the value of the mortgage multiplied by the ratio of U.S. situs assets to worldwide assets.

With a non-recourse mortgage, since the mortgage is collectable only against the property itself and not against any other assets of the individual, the full balance of the non-recourse mortgage can be deducted against the value of the U.S. situs asset in arriving at your tentative U.S. estate tax.

For Canadian tax purposes, if you use a non-recourse mortgage to refinance U.S. real estate property you may also benefit from the deductibility of interest on your Canadian tax return if the loan funds are used to purchase investments (stocks, bonds, mutual funds, etc.).

You should ask your professional cross-border advisor to determine whether using a non-recourse mortgage is right for you.

## • Irrevocable life insurance trust (ILIT)

Some Canadian residents purchase life insurance to cover the capital gains tax that arises upon their death due to the Canadian deemed disposition rules. Similarly, one of the simplest methods to pay for potential U.S. estate tax is to maintain sufficient life insurance.

Life insurance costs will depend on your age and health. You should also consider the effect it may have on your exposure to U.S. estate tax. Ironically, for purposes of calculating the value of your worldwide estate you must include the amount of the death benefit if you have incidents of ownership within the policy (generally meaning you had the ability to: name or change beneficiaries, borrow against the policy, access the cash value or assign or cancel the policy). Therefore, purchasing a life insurance policy can potentially increase your exposure to U.S. estate tax. First, it may increase the value of your worldwide estate, which could put you over the US $5 million threshold amount. Second, since the unified credit that can be claimed against your tentative U.S. estate tax is multiplied by the ratio of U.S. situs assets to your worldwide estate, an increase in the value of your worldwide estate will have the effect of reducing the portion of the unified credit you can use.

If obtaining life insurance will increase your exposure to U.S. estate tax, you should consider whether it makes sense for you to hold the policy in a special Irrevocable Life Insurance Trust (ILIT). With an ILIT you do not own the life insurance policy outright; a trust owns the life insurance policy such that you do not have incidents of ownership.

Aside from performing a cost benefit analysis to ensure that the estate taxes saved using an ILIT more than offset the cost to set it up and any annual fees, you should keep in mind that you will not have access to the cash surrender value or be able to borrow against the policy. This may not be wise if you may need the life insurance for investment or retirement purposes. Furthermore, the ILIT will be considered an *inter-vivos* trust and any investment income earned on the proceeds paid into the ILIT after your death will be subject to the highest marginal tax rates in Canada unless the income is paid or made payable to a beneficiary.

Ask your advisor at RBC for the article titled, *U.S. estate tax planning using life insurance,* for additional information.

## • Sell U.S. situs assets prior to death

This is one of the easiest and least complicated of solutions; however, it is generally applicable only when you become seriously ill or just before your anticipated death. The reason why this strategy may not be appropriate otherwise is that the sale of assets can trigger a premature tax liability in Canada with the realized capital gain. However, if you have capital loss carryovers to offset these capital gains this strategy may be more appealing.

Your advisor at RBC can assist you with reviewing possible tax loss selling strategies where you may trigger capital losses to offset the capital gains incurred, strategies to transfer a portion of the capital gain to your spouse and charitable giving strategies.

## • Qualified domestic trust (QDOT)

U.S. estate tax rules for U.S. citizens permit a complete unlimited deferral of U.S. estate tax when all property is left to a surviving U.S. citizen spouse. Unfortunately, this unlimited deferral does not apply if the surviving spouse is not a U.S. citizen. However, as discussed earlier, there is a marital tax credit that can serve to reduce the U.S. estate tax payable when U.S. situs assets are left to a married Canadian or U.S. resident surviving spouse.

A Qualified Domestic Trust (QDOT) will allow you to defer U.S. estate tax where U.S. situs assets are transferred to a QDOT for the benefit of your non-U.S. citizen surviving spouse. With a QDOT the U.S. estate tax is deferred until the U.S. situs assets are distributed from the QDOT (with some exceptions) or if there is any capital remaining in the QDOT upon the death of your surviving spouse.

Note that the U.S. estate tax that will be levied will be based on rates that existed in the year of your death as opposed to the rates that exist in the year your surviving spouse dies. A QDOT does not avoid U.S. estate tax, it only defers it.

The trust must meet specific criteria in order to qualify for QDOT status; therefore professional advice is a must. A QDOT may also qualify as a spousal trust for Canadian tax purposes. A cross-border tax or legal advisor should be consulted to determine if this strategy makes sense for you and to ensure the trust is set up properly.

- Consider severing property held in JTWROS

The IRS requires that all property you hold in JTWROS with your non-U.S. citizen spouse or any other individual be included in your estate for U.S. estate tax purposes unless you can demonstrate that the surviving joint tenant(s) contributed to the purchase of the assets. If you maintain appropriate records to support the contributions made, only your proportionate share of the assets based on your contributions will be included in your estate.

Ownership of U.S. property through JTWROS is not generally recommended for Canadians. To illustrate, let's say that a married Canadian couple each contribute 50% to the purchase of a property in Arizona. One-half of the fair market property value will be subject to U.S. estate tax at the first spouse's death. The deceased spouse's interest in the property is automatically transferred to their surviving spouse at the time of the first spouse's death. At the time of the surviving spouse's death, the full value of the property will be included in their taxable estate. There is a credit that may reduce the U.S. estate tax at the surviving spouse's death if he/she passes away within 10 years of the date of the first; however this credit is significantly reduced on a sliding scale after 2 years. The result is that the same U.S. property may be subject to U.S. estate tax twice in the same generation.

If you hold U.S. property in JTWROS, you may wish to consider severing the property based on each tenant's contributions and hold your interest as tenants in common, which is discussed next.

- Hold U.S. situs property through a tenancy in common

A tenancy in common form of ownership may be more beneficial than JTWROS. It is the ownership of a property by two or more individuals together but without the right of survivorship that is found in a joint tenancy. Each tenant in common may own an equal or unequal share in the property. Upon death of one tenant, only that tenant's share in the property may be subject to U.S. estate tax, not the full value of the property. Also, on the death of one of the tenants, his or her interest does not automatically pass to the other tenants in common. Instead, the share passes (through the deceased's Will) to their heirs and allows more flexibility to implement other U.S. estate tax planning strategies (such as a testamentary trust or a QDOT, discussed earlier in the article).

If co-owners hold real estate through a tenancy in common instead of JTWROS, each co-owner will be able to apply a valuation discount when determining the fair market value of their respective share of the property since a divided interest in the property is less marketable than a sole interest. Some legal experts indicate a reduction of the fair market value by approximately 20% is reasonable. This reduction will decrease your taxable estate and thus reduce your exposure to U.S. estate tax.

Holding assets through a tenancy in common may also pose certain ownership issues, especially where this form of ownership is used to own property along with children. For example, a tenant in common can sell his or her share in the asset to someone else, put a mortgage on his or her interest or use it as collateral, or give it to someone else as a gift.

Tenancy in common and U.S. revocable living trust (RLT)

For individuals who hold U.S. real property as tenants in common, there are some U.S. legal experts that suggest a strategy of using a U.S. revocable living trust (RLT) to hold each individual's interest. Holding the interest in a RLT will not avoid U.S. estate tax, however a properly structured U.S. RLT may avoid U.S. probate and potential administrative delays in dealing with U.S. guardianship should a spouse become incapacitated. It may also protect beneficiaries against creditors and (in a marriage breakdown) prevent a beneficiary's divorcing spouse from realizing rights to the property. The transfer of each spouse's interest to a U.S. RLT may avoid U.S. gift tax and Canadian deemed disposition rules.

A more detailed discussion of the use of RLTs is beyond the scope of this article. Due to the complexity associated with this strategy, it is imperative that you consult with a professional cross-border advisor for more details.

- ## Hold U.S. situs assets in a Canadian corporation

Shares you hold in a bona fide Canadian corporation (e.g. holding company incorporated in Canada) are generally not subject to U.S. estate tax. Therefore, it may be possible to use a Canadian corporation to hold certain U.S. assets to insulate you from U.S. estate taxes.

You must consider the cost associated with using this strategy. Using a corporation involves additional tax filings and financial reporting expenses, as well as possible corporate capital tax liabilities. Furthermore, this strategy may result in the payment of a larger current tax liability than a strategy where the assets are held personally due to the integration of the Canadian holding company's tax situation and the shareholder's personal tax situation.

Using a Canadian corporation to hold personal use U.S. assets such as vacation property may be undesirable. The IRS might disregard the corporation as providing insulation of its U.S. property from U.S. estate tax, especially if: you transferred the property to the corporation; the only asset of the corporation is the real property; only the shareholder and his/her family use the property; and/or corporate formalities are not followed. Moreover, because the U.S. property is owned by a corporation, on a sale the 15% preferential long-term capital gain rate for U.S. tax purposes which is presently applicable to individuals, trusts, estates and partnerships owning the property for more than a year is not available. Instead, the corporation is taxed at a rate of up to 35% federally in the U.S. In some states (such as Florida) individuals are not subject to tax, but corporations are. This adds a few additional percentage points of tax on to the sale. Note that many U.S. condominium associations do not permit ownership by a corporation.

In addition, the Canada Revenue Agency (CRA) may assert that the rent-free use of such personal assets held in a corporation represents a taxable shareholder benefit to you. There is an administrative exception to this CRA policy if you had established a Canadian corporation on or before December 31, 2004 for the sole purpose of holding U.S. vacation property for use by you and your family.

Before proceeding with a strategy of using a Canadian corporation to hold U.S. situs assets, it is important that the full circumstances of your plan be reviewed by a professional tax advisor who can review the risks from both Canadian and U.S. perspectives to determine whether use of a Canadian corporation can achieve the desired objectives.

- ## Hold U.S. real property in a Canadian partnership

There are some experts that suggest holding U.S. situs assets in a Canadian partnership with a family member instead of a Canadian corporation. With this complex strategy, it may be possible to elect to treat the Canadian partnership as a corporation for U.S. tax purposes, using what is referred to as "check the box" rules, thereby potentially avoiding U.S. estate tax as previously mentioned.

It is possible that the IRS may ignore this structure if it does not have a business purpose (i.e. the sole activity of the partnership is to hold the real estate property and not carry on a business). The IRS may also assert that the partners have retained an interest in the real estate where the partners have a right to redeem their partnership interest in exchange for the real estate property.

Since the structure will be viewed as a partnership for Canadian tax purposes, some of the negative Canadian tax consequences discussed above associated with owning U.S. real property inside a Canadian corporation may be avoided. However, if the structure will be considered a corporation for U.S. tax purposes, the U.S. income tax treatment described above may still apply resulting in a higher rate of tax on the sale of the property.

Due to the complexity of this strategy, it is imperative that you consult with a qualified tax advisor for more details.

- ## Hold U.S. real property in a Canadian trust

U.S. real property owned by a properly structured Canadian irrevocable inter-vivos trust may not be subject to U.S. estate tax. This strategy is especially beneficial if used by a married couple and the trust is established before the property's purchase. With this technique, one spouse creates the trust and funds it with the required amount of cash to purchase the property. The other spouse may be a trustee and beneficiary (along with your children, if desired). However, the spouse who created and funded the trust cannot be a trustee of the trust or have an interest in the property.

It is possible to transfer ownership of a U.S. real property to a properly structured trust to avoid U.S. estate tax. However this transfer of ownership is considered to be a gift and therefore any U.S. gift tax and Canadian capital gain tax that may be triggered on the disposition must be considered. A U.S. revocable living trust discussed earlier may be considered as an alternative strategy.

Since the structure is viewed as a trust for Canadian tax purposes, some of the negative Canadian tax consequences associated with owning U.S. real property inside a Canadian corporation may be avoided. However, the potential impact of the deemed disposition by a Canadian-resident trust of all of its capital property on the 21st anniversary date of the creation of the trust must be considered. The 21 year deemed disposition issue may be avoided if a qualified spousal trust is used and children are not included as beneficiaries.

Due to the complexity associated with this strategy, it is imperative that you consult with a professional cross-border advisor for more details.

- Transfer U.S.-based retirement plans to an RRSP

If you spent time working in the U.S., you may have accumulated funds in a U.S.-based retirement plan such as a 401(k), a traditional Individual Retirement Account (IRA) or another U.S. retirement plan. For U.S. estate tax purposes, assets held in a U.S.-based retirement plan are considered U.S. situs assets regardless of how these funds are invested. However, assets held in a registered retirement savings plan (RRSP) are not considered U.S. situs assets with the exception of U.S. situs securities inside the plan.

You may be able to reduce or eliminate your exposure to U.S. estate tax by transferring your U.S.-based retirement plan to an RRSP in Canada. Ask your RBC advisor for the article titled, *Transferring U.S. Based Retirement Plans to an RRSP,* for more information on this strategy.

- Make charitable donations

When U.S. situs property, on which U.S. estate tax would otherwise be payable, is given or bequeathed to a U.S. charitable organization, the bequest can be used to reduce the amount of U.S. situs property on which U.S. estate taxes are calculated. The U.S. charitable organization must be operated exclusively for religious, charitable, scientific, literary or educational purposes and your Will must contain specific provisions for the donation of the U.S. situs property.

## U.S. estate tax return filing requirements

The U.S. estate tax return for Canadians (IRS Form 706-NA) is not required to be filed if the value of your U.S. situs assets is US $60,000 or less. However, if this threshold is exceeded, your executor or personal representative has the responsibility to file a U.S. estate tax return even if your worldwide estate is valued at less than US $5 million and U.S. estate tax is not payable.

The U.S. estate tax return must be filed with the Internal Revenue Service (IRS) within nine months of the date of death unless an extension of time is granted. Any U.S. estate tax payable must be paid within nine months after death. Note that an extension of time to file the U.S. estate tax return does not extend the due date for payment of your U.S. estate tax liability. There are severe sanctions under the U.S. Internal Revenue Code should your executor or personal representative knowingly avoid filing the necessary return. The estate could be subject to significant penalties and the executor or personal representative could face imprisonment. There are also substantial penalties for understating the value of assets.

## Planning beyond 2012

What happens if in 2013, the U.S. estate tax rate reverts back to a maximum 55% and the exemption amount decreases to US $1 million? This possibility should be considered in your U.S. estate tax planning. Canadians with significant assets should still plan to minimize their exposure in the face of U.S. estate tax uncertainty in 2013 and beyond.

If you own U.S. situs assets or plan to purchase U.S. real estate, talk to your tax advisor regarding your exposure to U.S. estate tax and the relevant strategies you may use to reduce your exposure.

## Appendix A – U.S. estate tax exclusion, unified credit and top marginal rates

| Year | Exclusion Amount | Unified Credit | Max / top tax rate |
|---|---|---|---|
| 2001 | $675,000 | $220,550 | 55% |
| 2002 | $1 million | $345,800 | 50% |
| 2003 | $1 million | $345,800 | 49% |
| 2004 | $1.5 million | $555,800 | 48% |
| 2005 | $1.5 million | $555,800 | 47% |
| 2006 | $2 million | $ 780,800 | 46% |
| 2007 | $2 million | $ 780,800 | 45% |
| 2008 | $2 million | $ 780,800 | 45% |
| 2009 | $3.5 million | $1,455,800 | 45% |
| 2010 | $5 million or NIL with special election | $1,730,800 or n/a | 35% or NIL |
| 2011 | $5 million | $1,730,800 | 35% |
| 2012 | $5 million | $1,730,800 | 35% |
| 2013 * | $1 million * | $345,800 * | 55% * |

* Assumes no further legislation is enacted.

## Appendix B – Graduated U.S. estate tax rates 2010-2012

| Column A: Taxable Amount Over | Column B: Taxable Amount Not Over | Column C: Tax on Amount in Column A | | Column D: Rate of Tax on Excess Over Amount in Column A |
|---|---|---|---|---|
| $0 | $10,000 | $0 | Plus | 18% |
| $10,000 | $20,000 | $1,800 | Plus | 20% |
| $20,000 | $40,000 | $3,800 | Plus | 22% |
| $40,000 | $60,000 | $8,200 | Plus | 24% |
| $60,000 | $80,000 | $13,000 | Plus | 26% |
| $80,000 | $100,000 | $18,200 | Plus | 28% |
| $100,000 | $150,000 | $23,800 | Plus | 30% |
| $150,000 | $250,000 | $38,800 | Plus | 32% |
| $250,000 | $500,000 | $70,800 | Plus | 34% |
| $500,000 | $750,000 | $155,800 | Plus | 35% |
| $750,000 | $1,000,000 | $243,300 | Plus | 35% |
| $1,000,000 | $1,250,000 | $330,800 | Plus | 35% |
| $1,250,000 | $1,500,000 | $418,300 | Plus | 35% |
| $1,500,000 | $2,000,000 | $505,800 | Plus | 35% |
| $2,000,000 | $2,500,000 | $680,800 | Plus | 35% |
| $2,500,000 | $5,000,000 | $855,800 | Plus | 35% |
| $5,000,000 | - | $1,730,800 | Plus | 35% |

# Appendix C - Sample U.S. estate tax calculation for Canadians

Mrs. C, a Canadian resident has U.S. situs assets valued at US $2,000,000 and a worldwide estate valued at US $12,500,000. Does Mrs. C have exposure to U.S. estate tax?

**STEP 1: Compare the value of the U.S. situs assets and the worldwide estate to the U.S. estate tax thresholds**

Since the value of Mrs. C's U.S. situs assets is greater than US $60,000 and the value of her worldwide estate is greater than US $5 million, there may be a U.S. estate tax exposure so a calculation is required to quantify it.

**STEP 2: Using Appendix B, look up the U.S. estate tax value on US $2,000,000 of U.S. situs assets**

The tentative U.S. estate tax on US $2,000,000 of U.S. situs assets is US $680,800. Mrs. C can deduct liabilities (which may need to be prorated) related to the U.S. situs assets but lets assume there are none.

**STEP 3: Determine the prorated U.S. estate tax unified credit that can be deducted**

The non-refundable unified credit for years 2010 to 2012 is US $1,730,800. For Canadians like Mrs. C the amount of the unified credit that can be deducted is a prorated amount based on the proportion of the fair market value of U.S. situs assets to the worldwide estate.

Ratio of U.S. situs assets to worldwide estate:
US $2,000,000 ÷ US $12,500,000 = 16%

Prorated U.S. estate tax unified credit:
US $1,730,800 x 16% = US $276,928

**STEP 4: Subtract the prorated unified credit in step 3 from the U.S. estate tax from step 2**

Net U.S. estate tax payable before applying the marital credit deduction (if applicable):
US $680,800 – US $276,928 = US $403,872

If Mrs. C was not married US $403,872 would be her U.S. estate tax exposure.

**STEP 5: If you are married to a Canadian or U.S. resident of the opposite sex (i.e. same-sex spouses are not considered married and common-law partners may not be considered spouses) and leave your assets to your spouse you can deduct an additional non-refundable marital credit**

The marital credit is equal to US $276,928 which is the lesser of:
a) the prorated unified credit calculated in step 3 (i.e. US $276,928); and,
b) U.S. estate tax otherwise payable on U.S situs assets not transferred to a spouse (i.e. US $403,872)

**STEP 7: Subtract the marital credit in step 5 from the U.S. estate tax payable from step 4**

Net U.S. estate tax after deducting the marital credit:
US $403,872 – US $276,928 = US $126,944
Mrs. C's U.S. estate tax using the unified credit and marital credit is US $126,944.

Canadians may offset their Canadian tax liability attributable to the U.S. situs assets with a foreign tax credit on their Canadian final tax return for the U.S. estate tax paid.

Note: This calculation is an estimate for Canadians holding U.S. situs property. This calculation does not apply to U.S. citizens, greencard holders or U.S. residents domiciled in the U.S.

# Appendix D – Common U.S. real property ownership options for Canadians

**This table is provided for informational purposes only. You should consult a tax or legal advisor to ensure that your own circumstances are taken into consideration before taking any actions in order to ensure that you achieve the desired results.**

| Ownership structure | Avoids U.S. estate tax | Complexity | Other issues to consider |
|---|---|---|---|
| **Rent** | Yes | Low | No home ownership benefits |
| **Sole owner** | No | Low | U.S. state probate and guardianship issues in cases of incapacity |
| **Tenants in common** | May minimize | Low | U.S. state probate and guardianship issues in cases of incapacity<br><br>Divided interest can be sold or bequeathed to anyone |
| **JTWROS** | No | Low | Avoids U.S. state probate on first death |
| **U.S. revocable trust** | No | High | Divided interest can be sold or bequeathed to anyone |
| **Cdn. corporation** | Yes * | High | Higher cost to set up; higher tax rate in U.S. on sale; shareholder benefit |
| **Cdn. irrevocable trust** | Yes * | High | Settlor loses control; 21 year deemed disposition rule |
| **Cdn. partnership** | Yes * | Highest | Higher tax rates in U.S. on the sale of property if treated as corporation |

* If structured properly