TAB 6

Canada-U.S. Cross Border Estate Planning Issues

Katherine E. Cauley, Esq.
Britta L. McKenna, Esq.
Hodgson Russ LLP (Buffalo)

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6

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Katherine E. Cauley, Esq.
Britta L. McKenna, Esq.
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Introduction

The United States (U.S.) federal taxation regime taxes the transfer of assets both during life and at the death of a taxpayer. U.S. estate, gift and generation-skipping taxes (collectively, "transfer taxes") affect U.S. citizens (even if residing outside the United States), non-U.S. citizens domiciled in the United States, and non-U.S. citizens not residing in the United States to the extent they own "U.S. situs" property.[1]

The U.S. transfer tax system is currently unsettled. Legislative changes are anticipated but unpredictable. Repealed for 2010 only, the estate tax returns in 2011 with higher rates and a lower exemption amount (discussed more fully herein). Consequently, the U.S. transfer tax system casts a much broader net than in the recent past. Careful planning to minimize U.S. transfer tax exposure is more important than ever.

The first part of this analysis summarizes pertinent U.S. rules governing transfer taxes, and, to a lesser extent, income taxes, which, though relevant in the cross-border tax planning realm, are generally not as compelling as the potential application of U.S. transfer taxes. The second part of this analysis focuses on Canadian ownership of U.S real property and offers a sampling of tax planning strategies for Canadians who plan to acquire U.S. real property for personal use.

A. U.S. Transfer Taxes

1. United States Citizens

The U.S. transfer tax system applies differently to citizens and non-citizens of the United States; therefore, determining citizenship is a threshold question. Subject to limited exceptions, an individual born in the U.S. is a U.S. citizen, regardless of the citizenship of the individual's parents. But a child born abroad to a U.S. citizen parent may also be a U.S. citizen (from birth) if certain criteria relating to the U.S. citizen parent's physical presence in the U.S. are met. For individuals born abroad to a U.S. parent, the rules for determining U.S. citizenship are complex, and the determination of citizenship is based on the rules in effect at an individual's birth. U.S. citizenship carries with it tax filing requirements and income and transfer tax consequences, with potentially significant penalties for failure to comply. It is therefore critical to determine citizenship to ensure proper compliance.

(a) Estate Tax

U.S. estate tax is imposed on the taxable estate of every decedent who is a citizen of the United States at the time of his or her death.[2] The starting point for calculating the taxable estate is a determination of the gross estate. The gross estate of a U.S. citizen decedent is comprised of the value at death of all property, real or personal, tangible or intangible, situated anywhere in the world, owned by the decedent at death.[3] This includes property owned individually by the decedent and jointly with another[4], life insurance owned by the decedent[5], annuities[6], assets over which the decedent has a general power of appointment[7], and assets transferred during life revocably[8], with a retained interest[9], or with a reversionary interest[10]. For property owned jointly by a husband and wife, one-half of the value of the joint property is includable in the estate of the first to die, although a different rule applies in non-spousal joint tenancy situations.[11] Unlike the Canadian deemed disposition tax, which taxes only an asset's gain at the death of the owner, the entire value of an asset is included in a decedent's gross estate for U.S. estate tax purposes. This can seem particularly harsh from a Canadian perspective.

After the gross estate is determined, credits, deductions and exclusions may be available to arrive at the taxable estate on which estate tax is imposed.[12] Deductions are available for, among other things, the decedent's funeral expenses, estate administration expenses, state estate taxes paid, and creditor's claims, as well as for qualifying charitable and marital bequests, discussed in greater detail below.[13]

The estate tax was repealed for one year in 2010, but is scheduled to return in 2011 with a maximum effective rate of 55%.[14] For gross estates in excess of the available exemption (discussed more below), an estate tax return, Form 706, is due 9 months from the decedent's date of death.[15] Any estate tax liability must also be paid at that time.

<u>Estate Tax Exemption</u>. U.S. citizens are entitled to an estate tax exemption.[16] The amount of this exemption has steadily increased over the last decade to a high of $3.5M[17] in 2009.[18] Because the estate tax was repealed for one year in 2010, there currently is no estate tax exemption. As of January 1, 2011, when the estate tax is reintroduced, the exemption amount is $1M.[19]

Charitable Deduction. Any assets left to qualifying charities at death are eligible for an unlimited charitable deduction from the U.S. estate tax. Qualifying charitable organizations can include foreign charities, so long as they meet the same requirements imposed on U.S. charities.[20]

Marital Deduction. An unlimited marital deduction from the estate tax is available for assets left in a qualifying manner to a surviving spouse.[21] This includes assets left outright to the surviving spouse as well as in qualifying trusts (namely a QTIP – qualified terminable interest property trust). In order to qualify for the marital deduction, the surviving spouse must be the only beneficiary of the QTIP during his or her lifetime and must receive all the income from the trust at least annually.[22] In addition, the Executor of the decedent's estate must elect to treat the trust as a QTIP on the estate tax return. Any assets remaining in the QTIP at the death of the surviving spouse are includible in his or her gross estate.

Thus, if all property (or at least property in excess of the exemption) passes from the estate to charity or a surviving U.S. citizen spouse (either outright or in a qualifying trust), there is no U.S. estate tax on the death of the first spouse.

Income Tax Considerations. Generally, all assets included in a decedent's taxable estate receive a basis step-up to the fair market value of the asset as of the decedent's date of death (regardless of whether estate tax is actually paid).[23]

In 2010, during the one year repeal of the estate tax, a system of carry-over basis applies. The beneficiaries of estates of decedents dying in 2010 retain the decedent's basis in any inherited assets, subject to the following two adjustments.[24] In 2010, every decedent is entitled to a basis adjustment of $1.3M, with an additional $3M basis adjustment available to assets passing from a decedent to a surviving spouse in a qualifying manner.[25]

Special Asset Considerations. Every individual needs to have sufficient assets in his or her name alone, without joint owners or designated beneficiaries, in order to maximize the use of the estate tax exemption. Therefore, jointly owned property and property with beneficiary designations (such as life insurance, IRAs, and 401(k)s), pose special considerations in estate planning for U.S. citizens. Owning all (or substantially all) of a married couple's property in joint tenancy may adversely impact effective utilization of the estate tax exemption, and beneficiary designations need to be carefully considered in that respect as well.

Special planning is usually recommended for a married couple with assets in excess of the exemption equivalent, in order to ensure the exemptions are fully utilized. This usually involves appropriate titling of assets, appropriate beneficiary designations and use of lifetime and/or testamentary trusts.

(b) Gift Tax

U.S. citizens are subject to gift tax on transfers made during life, subject to the exclusions, exemptions, and deductions discussed below. The gift tax rate is generally the maximum estate tax rate in effect.[26] For 2010 (when there is no corresponding estate tax), the gift tax rate is 35%. On January 1, 2011, the gift tax will increase to 55%. Taxable gifts must be reported (and any associated gift tax paid) on a Form 709 due on April 15th of the year following the year the gift was made.

Annual Gift Tax Exclusion. U.S. citizens have an annual gift tax exclusion of $13,000 per donee, per year (indexed for inflation).[27] Use of the annual gift tax exclusion does not require the filing of a gift tax return.[28] Annual exclusion gifts generally must be of a present interest, and not a future interest. There are therefore certain additional requirements that must be followed when making annual exclusion gifts to a trust on behalf of a donee.

Tuition & Medical Expenses. There is also an unlimited gift tax exclusion for amounts paid on behalf of a donee for educational or medical purposes, provided that the gift must be made directly to the educational or medical provider.[29]

Lifetime Gift Tax Exemption. In addition to the annual gift tax exclusion, U.S. citizens have a lifetime gift tax exemption in the amount of $1M. Use of any of the $1M gift tax exemption reduces the available U.S. estate tax exemption on a dollar-for-dollar basis, and must be reported on a Form 709.

Marital Deduction. Gifts made to a U.S. citizen spouse during life, of any amount, qualify for the marital deduction from gift tax.[30] As discussed more below, the marital deduction is limited to a certain annual amount (presently $134,000) if the donee spouse is not a U.S. citizen.[31]

Charitable Deduction. As with the marital deduction, gifts of an unlimited amount can be made to qualifying foreign or domestic charities without the imposition of gift tax.[32]

There is no income tax event associated with gifts. The donee of the gift assumes the donor's basis in the gift.[33] The donor of a gift is primarily liable for paying the gift tax. A donee may also be liable for the gift tax if it is not paid by the donor.

(c) Generation-skipping Transfer ("GST") Tax

U.S. citizens are also subject to GST tax on transfers that "skip" a generation (for example, a gift from grandparent to grandchild, thereby avoiding gift or estate taxation at the child's generation).[34] The GST tax mirrors the estate tax provisions, and there is therefore no GST tax in 2010. As with the estate tax, the GST tax is scheduled to return on January 1, 2011, with a maximum tax rate of 55%. As of January 1, 2011, every individual will have a GST exemption of $1.1M (indexed for inflation), allocable to gifts made during life or at death.

2. <u>Non-U.S. Citizens</u>

Non-citizens of the United States are divided into two categories for U.S. transfer tax purposes – Resident Aliens (RAs) and non-Resident Aliens (NRAs). The test to determine residency for tax purposes depends on the <u>type</u> of taxation at issue. An individual is considered a Resident Alien for income tax purposes (and taxed on worldwide income) if he or she meets one of two tests -- (1) the "green card" test, or (2) the substantial presence test. An individual meets the green card test if he or she is granted a green card, allowing him or her to reside permanently in the United States. An individual meets the substantial presence test by being present in the U.S. for a certain number of days in a calendar year.

For transfer tax purposes, a resident is an individual who has his or her domicile in the United States.[35] The definition of a resident for transfer tax purposes is therefore more subjective and difficult to ascertain than residency for income tax purposes because the transfer tax definition requires a determination of domicile, which has a subjective component.

An individual is considered to be domiciled in the U.S. if he or she is physically present in the U.S. with the intent to remain permanently. In determining an individual's intent to permanently remain, many factors, including the following, are considered: length of presence in the U.S., especially compared to length of presence in other countries; location of family and friends; location of items of financial or sentimental value to individual; location of business interests; declarations of residency; and country of voter registration, driver registration and the like. Because an individual must assert an intention to remain permanently in the United States in order to obtain a green card, holding a green card is a strong indication of intent. Non-green card holders may still be considered domiciled in the U.S. if the requisite factors show an intent sufficient to establish domicile.

(a) Resident Aliens Domiciled in the U.S.

(i) Estate Tax

As with U.S. citizens, U.S. estate tax is imposed on the worldwide estate of every decedent who is domiciled in the United States at the time of his or her death ("Resident Aliens"). Thus, Resident Aliens are, for estate tax purposes, subject to U.S. estate tax on their worldwide assets just as a U.S. citizen is. A Resident Alien is entitled to the same estate tax exemption amount as a citizen (unlimited for 2010, $1M as of January 1, 2011).

Marital Deduction. Bequests to non-citizen spouses are treated significantly different than bequests to a U.S. citizen spouse, however. Based on the concern that a non-citizen surviving spouse would leave the United States, and thus the property would escape estate taxation in the second spouse's estate, a bequest to a non-citizen spouse is not eligible for the marital deduction unless the bequest is in the form of a qualified domestic trust (a "QDOT").[36] In order to qualify as a QDOT, the trust must satisfy all the requirements of a Qualified Terminable Interest Property trust, the trust for a U.S. citizen spouse eligible for the marital deduction. There also must be at least one U.S. citizen or U.S. corporate trustee[37], and the U.S. trustee must have the right to withhold QDOT tax from any trust distribution.[38] U.S. estate tax is imposed on distributions of capital from the QDOT to the surviving spouse during his or her lifetime (unless for "hardship")[39], and any remaining balance is included in the estate of the surviving spouse at death.[40]

With respect to jointly-held property, where the surviving joint tenant is someone other than a U.S. citizen spouse, 100% of the value of the joint property is includable in the estate of the first joint tenant, unless it can be demonstrated what value the surviving joint tenant contributed toward the property.[41]

Credit for Taxes Paid. The estates of U.S. decedents and residents can claim a credit against U.S. estate tax for Canadian tax paid at death.[42]

(ii) Gift Tax

The gift tax rules applicable to U.S. citizens generally apply to Resident Aliens, except the gift tax unlimited marital deduction is not allowed for gifts to a spouse who is not a U.S. citizen. Rather, an annual exclusion amount (currently $134,000 and adjusted annually) is allowed for outright gifts made to a non-citizen spouse that otherwise would qualify for the marital deduction if the donee spouse were a citizen.[43]

(iii) GST Tax

Resident Aliens are subject to GST in the same manner as U.S. citizens. Transfers made from a grandparent to a grandchild or younger generation, during life or at death, are not subject to GST tax in 2010, but as of January 1, 2011, will be taxed at a top marginal rate of 55% to the extent they exceed the GST tax exemption of $1.1M.

While Resident Aliens are treated similarly to U.S. citizens in many ways, proper planning is essential to take advantage of all relief provided by U.S. law and applicable treaties.

(b) Non-Resident Aliens

(i) Estate Tax

Non-Resident Aliens ("NRA"s) are treated quite differently than U.S. citizens and Resident Aliens for estate tax purposes. U.S. estate tax applies only to the portion of an NRA decedent's gross estate which at the time of his or her death is situated in the United States.[44] U.S. situs assets include:[45]

1. real property located in the U.S.

2. tangible personal property located in the U.S.

3. stock in a U.S. corporation

4. debt obligations of U.S. persons, the U.S. government or any political subdivision thereof (with some exceptions).[46]

There are some less obvious rules that may result in exposure to U.S. estate tax for an NRA. If an NRA transfers property in trust, either during life or at death, the transferred property is deemed situated in the United States if it was situated in the United States at the time of transfer or at the time of death. If an NRA holds shares in a mutual fund, the situs may be deemed to be the situs of the assets held by the fund (if it is not taxable as a corporation for U.S. tax purposes). Thus, a mutual fund organized as a trust may be deemed a U.S. situs asset to the extent the mutual fund itself holds U.S. situs assets. An interest in a partnership or an entity taxable as a partnership (e.g., a "Limited Liability Company" or "LLC") may be a U.S. situs asset if the underlying partnership assets are located in the United States, although the law is unclear in this area. Annuities, stock options, and retirement proceeds, to the extent the obligation is that of a U.S. person or entity, are U.S. situs, although life insurance (even if provided by a U.S. company) is not.[47] Generally, amounts on deposit at U.S. banks (unless connected with a U.S. business) are not U.S. situs under a special exemption rule.[48]

These are only general guidelines, and because of the intricacies of these rules, any investment by an NRA that has a U.S. component should be examined carefully to determine any potential U.S. estate tax implications.

Estate Tax Exemption. Under U.S. domestic law, an NRA has only a $60,000 estate tax exemption equivalent.[49] The Third Protocol to the U.S. - Canada Treaty (the "Treaty") affords additional relief to Canadian citizens and residents. Under the Protocol, a Canadian citizen and resident is entitled to a potentially greater U.S. estate tax credit that exempts an amount equal in ratio to the credit for U.S. citizens as the value of the Canadian's U.S.-situs assets is to the value of his or her worldwide estate (the "pro-rated credit").[50] This exemption amount is determined by multiplying the applicable estate tax exemption for U.S. citizens by a fraction, the numerator of which is the value of the decedent's U.S. situs assets and the denominator of which is the value of the decedent's worldwide assets.

As with the exemption, the deductions an NRA is permitted to take against his or her U.S. estate tax are also prorated based on the proportion of the value of the U.S. situs assets to the decedent's worldwide assets.[51]

Thus, while the non-U.S. situs assets of a decedent are not subject to U.S. estate tax, they are relevant to determining the applicable U.S. exemptions and deductions. With the U.S. estate tax scheduled to return in 2011 with an exemption amount of $1M, the pro-rated exemption will afford lesser relief than it has in the past. Effective planning can involve shifting assets between spouses to increase a spouse's pro-rated exemption.

Marital Credit. A marital credit is also available, in addition to the pro-rated exemption, for property that passes to a surviving spouse in a manner that would qualify for the marital deduction if the surviving spouse was a U.S. citizen.[52] The credit is available if (1) the decedent was a U.S. citizen at the time of death or a resident of Canada or the U.S.; (2) the decedent's surviving spouse is a resident of either Canada or the U.S.; and (3) both the decedent and the surviving spouse were U.S. residents at the decedent's death or one or both was a Canadian citizen. The marital credit essentially doubles the pro-rated estate tax exemption. If the marital credit is utilized, however, the marital deduction (and QDOT election) discussed below is not available.

Marital Deduction. The marital deduction is available for transfers by an NRA to a U.S. citizen spouse or in a QDOT to a noncitizen spouse to the same extent allowed to a U.S. citizen or RA. As mentioned above, the marital deduction (and QDOT election) is not available if the marital credit is elected.

Charitable Deduction. A U.S. estate tax deduction is allowed for certain bequests made by a NRA to qualifying U.S. charities.[53] Bequests to non-U.S. charities are not eligible for the deduction.[54]

Credit for Taxes Paid. Under the Treaty, the estates of Canadian decedents can claim a deduction against Canadian income tax for U.S. estate tax paid on property situated in the U.S. at death.[55] It is therefore generally advisable to incur Canadian deemed disposition taxes and U.S. estate taxes in the same tax year (as opposed to, for example, U.S. property owned by a Canadian citizen that does not qualify for Canadian spousal rollover but could be covered by the marital credit for U.S. estate tax purposes) to ensure an offsetting credit can be obtained.

(ii) Gift Tax

NRAs are subject to U.S. gift tax on gifts of U.S. real property or tangible personal property situated within the United States at the time of the gift.[56] Lifetime transfers of intangible property, such as stock in a U.S. corporation, are not taxed for gift tax purposes.[57] As with the estate tax, an NRA's charitable deduction from gift tax is limited to gifts made to qualifying U.S. charities.[58]

(iii) GST Tax

For NRAs, U.S. GST tax is applicable on transfers that are subject to U.S. estate or gift tax.[59] Every NRA has a GST tax exemption of $1M.[60]

While the Treaty does afford some relief to NRAs, it does not rise to the level of U.S. citizens and residents, and will be significantly limited if legislation does not change the U.S. estate tax exemption amount of $1M as of January 1, 2011. Even if the applicable exemptions are sufficient to avoid U.S. estate taxation, properly structured Wills are needed to prevent any U.S. situs assets from again being exposed to U.S. estate tax in the estate of the surviving spouse.

A comprehensive discussion of planning considerations for NRAs is beyond the scope of this analysis. An overview of planning opportunities for Canadians owning U.S. real property follows, but ownership of U.S. real property, while perhaps the most obvious trigger, is only one consideration. Subtler U.S. connections should also be explored for possible U.S. transfer tax implications. An investment portfolio that includes stock in U.S. companies will trigger U.S. estate tax on death. Canadian parents of children living in the U.S., who may not have personal exposure themselves, should nonetheless consider the impact of U.S. estate tax on the children when structuring the children's inheritances. The failure to recognize a U.S. connection can have unintended and costly results. Identifying the U.S. tie and then planning for it is key.

B. Ownership of U.S. Real Property

The current economic conditions have resulted in many Canadians purchasing vacation properties or second homes in the United States. However, as discussed above, owning real property in the U.S. has the negative consequence of exposing Canadians to U.S. estate tax. Depending on the form of ownership, however, this exposure can potentially be completely avoided.

Joint Tenancy with Right of Survivorship. While one of the more popular ways to hold real property, a joint tenancy is generally not recommended for NRAs owning U.S. real property.[61] First, there is the risk of double U.S. estate inclusion. On the death of the first spouse, the entire value of the property is included in the decedent's estate, under the presumption that the decedent spouse contributed all the funds to acquire the property.[62] The entire property passes by operation of law to the surviving spouse, where the entire value will be again be subject to U.S. estate tax at the survivor's death.

Furthermore, a joint tenancy makes it more difficult to defer the U.S. estate tax until the death of the survivor. If the survivor is not a U.S. citizen, the property will not qualify for the marital deduction from U.S. estate tax because it is not passing to a QDOT for the survivor.[63] The Treaty marital credit may be available, but may not be sufficient to alleviate the entire U.S. estate tax liability on the first death (particularly with the lower estate tax exemption of $1M as of January 1, 2011).

Corporation. Having real property held in a Canadian corporation does not necessarily provide relief from U.S. estate tax. The IRS may look through the corporation to the underlying asset, especially if the property is the only asset of the corporation, the property is not used by anyone other than the shareholder and the shareholder's family, and the requisite corporate formalities are not followed. In addition, Canada may impute income to the shareholder from the rent-free use of the property under the "shareholder benefit" rule. Lastly, on the sale of the property, U.S. capital gain will be due on the difference between the original purchase price (plus capital improvements) and the sale price. This gain will be taxed at the corporate capital gain rate of 34%, as opposed to the long-term individual capital gain rate of 15%.

Partnership. Using a partnership to hold U.S. real property may or may not provide relief from the U.S. estate tax. There is no guidance as to how the IRS determines the situs of the partnership interests. If the IRS deemed the situs of a partnership interest to be the location of the partnership's property, the interest owner would be subject to U.S. estate tax on the U.S. assets held by the partnership. While it is possible that the IRS would determine the situs of the partnership interest using a different analysis, such as the domicile of the interest holder or the location of the partnership formation, there are other forms of ownership that shield the U.S. real property from U.S. estate taxation with more certainty.

Non-Recourse Mortgage. Non-recourse mortgages, which are secured only by the underlying property, have experienced increased popularity in recent years. A non-recourse mortgage allows a dollar-for-dollar deduction against the value of the property that is includible in a decedent's estate for U.S. estate tax purposes (as opposed to a conventional recourse mortgage, which only allows for a pro-rated deduction based on the ratio of the value of the U.S. situs property to the decedent's worldwide assets).[64] Not only are there disadvantages to a non-recourse mortgage, including higher interest rates, limitations on availability to generally 50-60% of the property's value, and no protection for property appreciation, the current real estate conditions in the U.S. have made non-recourse mortgages much more difficult to obtain.

Trust. A more effective planning tool is the use of an irrevocable trust to hold U.S. real property. A "residence trust" can be used in many situations, but works most effectively for a married couple, and is structured to avoid the inclusion of the U.S. real property in either spouse's estate for U.S. estate tax purposes, so long as specific requirements are met. One of the spouses (the "Grantor") creates the trust and contributes funds to the trust. There is no taxable event when the trust is created or funded for U.S. gift tax purposes, as long as U.S. situs assets are not used. The Grantor's spouse and descendants are the beneficiaries of the trust. In order for the trust not to be included in the estate of the Grantor for U.S. estate tax purposes, the Grantor can not be a beneficiary or a trustee of the trust. The Grantor's spouse can be the Trustee, so long as distributions of income and capital are limited by what is known as an ascertainable standard (i.e., health, support, maintenance or education). The U.S. situs real property is then purchased by the trust with the assets contributed to the trust by the Grantor. It is essential that the purchase contract be in the name of the trust and the funds for closing come from a trust account.

The Grantor's spouse and descendants, as beneficiaries of the trust, can use the property rent-free during their lifetimes. Under certain provisions of U.S. law, the Grantor is also permitted to use the property rent-free during his or her spouse's lifetime. The Grantor can also continue to contribute funds to the trust to cover any related costs.

Upon the death of the Grantor, the property held in the residence trust is not includable in his or her estate for U.S. estate tax purposes. The same is true at the death of the Grantor's spouse (even if he or she is the Trustee, so long as distributions from the trust are limited by an ascertainable standard).

The residence trust also has the added benefits of avoiding probate, protecting the property held in the trust from creditor claims and potentially allowing the U.S. long term capital gains rate to be available on a sale if the property is held for more than one year. This rate is presently 15% federally for 2010, as opposed to the 34% capital gain rate applicable if the real property is held by a corporation.

There are a few disadvantages to the residence trust that should be noted. If the Grantor's spouse predeceases the Grantor, the Grantor will have to pay fair market rent to continue to use the property. In addition, if the Grantor and his or her spouse divorce, the spouse can continue to use the property to the exclusion of the Grantor. However, provisions can be included in the trust agreement to protect the Grantor in the event of a divorce, by removing the other spouse as a beneficiary and trustee of the trust at that time.

While it is best to have the property purchased by the trust from the outset, the same beneficial U.S. estate tax result can be achieved by selling U.S. property previously purchased to the trust. In order to minimize the U.S. estate tax exposure, the sale transaction must be structured with terms that are as arm's-length as possible. Any gain from the sale will need to be reported on a U.S. non-resident income tax return (Form 1040NR) and is subject to tax in the U.S. at a 15% rate.[65] For that reason, it is most effective to use this technique for property that has little to no gain, or even a loss. Any gain from the sale also has to be included in the owner's income for Canadian tax purposes, but the U.S. tax is creditable against the Canadian tax (which will be higher, so there will be some residual Canadian tax owing).

Rental of U.S. Real Property. Rental property in the U.S. owned by a NRA is generally taxed at a flat U.S. withholding rate of 30%, unless the property it is effectively connected with the conduct of a U.S. trade or business.[66] If an "effectively connected" election is made, certain tax deductions, including depreciation, maintenance costs, and property taxes, are available.[67] In addition, the graduated income tax rates apply.

A U.S. income tax return will be required every year to report the rental income.

Summary

The rules governing U.S. estate, gift, and generation-skipping transfer taxes are broad in scope and complex. Proper structuring and planning are essential to minimize U.S. tax liability at every generation both during life and at death. Furthermore, with the unsettled state of the U.S. estate tax, plans implemented in prior years must continually be revisited to ensure continued effectiveness.

It goes without saying that Canadians contemplating acquiring U.S. real property for personal use should analyze their U.S. estate tax exposure and then take steps to minimize or eliminate it. For those for whom the Treaty exemptions and credits do not afford sufficient relief, a residence trust can be quite effective. Further, if the trust is properly structured and maintained, use and enjoyment of the property will be unaffected.

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[1] This paper does not address any state or local taxes that also may be applicable.

[2] Internal Revenue Code of 1986, as amended (hereinafter "IRC") § 2101(a).

[33] IRC § 2031.

[4] IRC § 2040.

[5] IRC § 2042(1).

[6] IRC § 2309.

[7] IRC § 2041(a).

[8] IRC § 2038.

[9] IRC § 2036.

[10] IRC § 2037.

[11] IRC § 2040(b)(1).

[12] IRC § 2051.

[13] IRC §§ 2053, 2054, 2055, 2056.

[14] A 5% surplus tax could also apply.

[15] An additional 6-month extension is available, but the estate tax must be paid by the original 9-month filing due date.

[16] IRC § 2010(a).

[17] All amounts are in U.S. dollars.

[18] IRC § 2010(e).

[19] *See* P.L. 107-16, Economic Growth and Tax Relief Reconciliation Act of 2001.

[20] IRC § 2522(a); Reg. §25.2522 (a)-1.

[21] IRC § 2056.

[22] IRC § 2056(a)(7).

[23] IRC § 1014.

[24] IRC § 1022(a).

[25] IRC § 1022(b) & (c).

[26] IRC §§ 2001(b), 2502(a).

[27] IRC § 2503(b)(1), indexed for inflation.

[28] Unless spouses opt to "gift-split."

[29] IRC § 2503(e)(2)(A) & (B).

[30] IRC § 2523(a).

[31] IRC § 2523(i).

[32] IRC § 2522.

[33] IRC § 1015.

[34] IRC § 2601.

[35] Regs. §§ 20.0-1(b)(2), 25.2501-1(b), 25.2511-3.

[36] IRC §§ 2056(d)(1)(A), 2056(A).

[37] IRC § 2056(a)(1). Because of the requirement of a U.S. Trustee, the QDOT may not qualify as a Canadian resident trust, prohibiting a spousal rollover. However, a competent authority request can be made to treat the QDOT as a resident of Canada. U.S. – Canada Treaty, Article XXIXB, Paragraph 5.

[38] IRC § 2056(a)(1).

[39] IRC § 2056A(b)(3).

[40] IRC § 2056A(b)(1).

[41] IRC § 2040(a).

[42] U.S. – Canada Treaty, Article XXIXB, Paragraph 7.

[43] IRC § 2523(i)(2).

[44] IRC §§ 2101(a), 2103.

[45] IRC § 2104.

[46] There is an exception for "portfolio" debt, for example.

[47] IRC § 2105.

[48] IRC § 2105.

[49] IRC § 2102(b)(1).

[50] Treaty, Article XXIXB, Paragraph 2.

[51] IRC § 2106.

[52] Treaty, Article XXIXB, Paragraph 3.

[53] IRC § 2106(a)(2)(A).

[54] IRC § 2522(b).

[55] Treaty, Article XXIXB, Paragraph 6.

[56] IRC § 2511(a).

[57] In contrast, U.S. corporate stock is taxable as U.S. situs property for estate tax purposes.

[58] IRC § 2522(b).

[59] Reg. § 26.2663-2.

[60] Reg. § 26.2663-2(a).

[61] Here, U.S. planning is frequently at odds with traditional Canadian estate planning which favors joint ownership as a means of avoiding probate (and probate tax).

[62] This presumption can be rebutted to the extent the surviving spouse can show that he or she contributed funds to the purchase of the property.

[63] A post-mortem QDOT can be established to hold the property, but is a complicated and lengthy process.

[64] Reg. § 20.2053-7.

[65] U.S. withholding tax is required to be paid at the time of sale under the U.S. Foreign Investment in Real Property Tax Act ("FIRPTA") rules. The owner can apply to have the FIRPTA withholding based on the actual amount of the gain, rather than on 10% of the purchase price as otherwise required under the FIRPTA rules. In addition, the client may also be required to pay state transfer tax based on the sale price at the time of closing.

[66] IRC § 871(a).

[67] Under IRC § 280A, these deductions may be limited for mixed-use property that is both rented and used personally.

Canada-U.S. Cross Border Estate Planning Issues

Katherine E. Cauley, Esq.
Britta L. McKenna, Esq.
Hodgson Russ LLP*
The Guaranty Building
140 Pearl Street, Suite 100
Buffalo, NY 14202
716.856.4000

150 King Street West
Suite 2309
Toronto, Ontario
M5H 1J9
416.595.5100
www.hodgsonruss.com

*Practice Restricted to U.S. Law

Hodgson Russ LLP
ATTORNEYS

U.S. Estate Taxation of NRAs

- Only subject to U.S. estate tax on U.S.-situs assets
  - ☐ real property located in the U.S.
  - ☐ tangible personal property located in the U.S.
  - ☐ stock in a U.S. corporation
  - ☐ debt of U.S. company or persons
    - Annuities, stock options, and retirement proceeds (if an obligation of U.S. individual or entity)

- Life insurance → not U.S.-situs
- Non-business deposits at U.S. bank → not U.S.-situs
- Interest in partnership holding U.S.-situs assets → ???

NRA Pro-Rated U.S. Estate Tax Exemption

- Under U.S.-Canada Treaty, NRA has pro-rated U.S. estate tax exemption equal to:

$$\frac{\text{U.S.-situs assets}}{\text{Worldwide assets}} \times \text{U.S. estate tax exemption}$$

U.S. Estate Tax 2010

- Repealed
- Carryover basis regime
  - May cause mismatch in Canada/U.S. income taxation
    - Two different taxpayers?
- "Exemptions" are increases to basis in following amounts:
  - \$1.3M (only \$60K increase for Canadians)
  - Additional \$3M for assets to spouse (but is this available to Canadians?)

U.S. Estate Tax 2011

- Estate tax reintroduced
- \$1M exemption (55% maximum rate)
  - Compare with 2009's \$3.5M exemption & 45% maximum rate
- Legislative changes likely
- U.S. estate tax on U.S.-situs property generally creditable against Canadian tax at death

Marital Credit

- Marital credit also available under Treaty for assets passing to spouse in qualifying manner
- Essentially doubles the pro-rated exemption
- Can't also use QDOT

Marital Deduction

- Available for transfers by an NRA to a U.S. citizen spouse or in a QDOT to a noncitizen spouse
- QDOT
  - All income to spouse
  - Spouse as only beneficiary
  - Must have U.S. citizen/corp. Trustee
  - U.S. estate tax imposed on distributions of capital
  - Balance included in estate of surviving spouse at death
  - Not available if the marital credit is utilized

U.S. Real Property Owned by NRAs

Possible Approaches for NRA Ownership of U.S. Real Property

- Individually
  - Joint tenants with right of survivorship
  - tenants in common
  - sole individual owner
- Partnership
- Canadian corporation
- Trust

Joint Ownership
Bad U.S. Tax Result

- Joint Tenants with Right of Survivorship
- Tenancy by the Entirety
- "Husband and Wife"
  - □ First spouse to die is taxable on full value unless it can be proven the other spouse supplied some or all of the consideration
  - □ Property passes by operation of law to surviving spouse & is taxed in survivor's estate too

- **PLANNING NOTES**:
  - □ Can sever existing tenancy (so spouses hold as tenants in common) based on contributions by each spouse, and plan to reduce estate tax by using appropriate testamentary trusts
  - □ If property not severed in accordance with contributions by each spouse → gift

 11

- Tenancy in Common / Individual Ownership
  - □ May be viable form of ownership, depending on total assets
  - □ Trusts in Wills to keep out of any recipient beneficiary's estate
- Partnership Ownership
  - □ Unknown result

 12

Corporate Ownership

- Use of corporation to hold U.S. real estate is generally not desirable:
  - Possible U.S. estate tax exposure (may look through)
  - Canadian "shareholder benefit" issue
  - Higher tax on sale (up to 40%+ versus as low as 15% if not owned through corporation)

Trust as Owner

- Settlor ("grantor") forms trust for benefit of spouse and descendants, funds it with cash, and trust purchases U.S. real property
- Grantor can also use property so long as spouse is beneficiary
- Avoids "shareholder benefit" issue
- Preserves ability to obtain beneficial (15% federal) U.S. long term capital gains rate on sale (if held > 1 year)

- Terms of Trust
  - □ Standard for distributions limited to ascertainable standard ("health, education, maintenance and support") if beneficiary is a trustee
  - □ Provide flexibility to appoint Independent Trustee who can distribute for any reason <u>and</u> who can terminate trust (e.g., 21 year rule)

- Potential drawbacks
  - □ What if NRA has no spouse?
  - □ Divorce
  - □ Death of beneficiary spouse
    - surviving spouse should rent at fair market value
  - □ 21 Year Rule