

# Estate Tax Update

## Temporary Uncertainty in U.S. Estate Tax Regime Hinders Planning

This *Estate Tax Update* Is Affected

### Estate tax uncertainty

The attached *Estate Tax Update* assumes that the 2009 U.S. estate tax regime is extended to 2010 and beyond. However, **the U.S. did not pass legislation in 2009 to extend the 2009 federal estate tax rate and exemption level to 2010. As a result, the federal estate tax has been temporarily repealed from January 1, 2010, through December 31, 2010.**

Unless legislation is passed in 2010, the federal estate tax will be reinstated in 2011, with:

- an exemption of only \$1,000,000 (indexed for inflation); and
- a maximum tax rate of 55% (60% on the portion of the estate between \$10,000,000 and \$20,000,000).

Speculation that in 2010 the U.S. will pass estate tax reform legislation retroactive to January 1, 2010, has sparked uncertainty in respect of the federal estate tax.

These changes affect U.S. citizens. They also affect Canadians because the relief provided under Article XXIX-B of the Canada-United States Income Tax Treaty is tied to the U.S. exemption.

### Gift tax unaffected

Unlike the estate tax, the federal gift tax has not been repealed in 2010. The lifetime exemption from gift tax continues to be \$1,000,000 and is not indexed for inflation. Therefore, a person may make up to \$1,000,000 of aggregate lifetime gifts. For 2010, the top marginal gift tax rate drops from 45% to 35%.

### Extra caution required

The current state of affairs in the U.S. makes planning extremely difficult. This *Estate Tax Update* is to be relied on only in the event that the 2009 regime is reinstated. As always, but especially in light of the current uncertainty, you should contact your tax adviser before proceeding with any U.S. estate planning.

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## Cross-border Estate Planning: Effect of Fifth Protocol to the Canada-U.S. Income Tax Treaty

On September 21, 2007, after nearly ten years of negotiation, the United States and Canada jointly released the fifth Protocol (the Protocol) to the *Canada-U.S. Income Tax Convention* (Treaty). The Protocol includes important changes that may affect cross-border estate planning in the areas of:

- charitable deductions; and
- taxes imposed by reason of death on:
  - Registered Retirement Savings Plans (RRSPs); and
  - U.S. stock options.

These changes will become effective the later of January 1, 2008, and the date the Protocol is ratified.

### Charitable Donation Planning

Paragraph 1 of Article XXIX-B (Taxes Imposed by Reason of Death) of the current Treaty will be replaced by new language that restricts the cross-border donation planning opportunities for Canadian residents who are not U.S. citizens.

Under the existing provision, the U.S. provides an estate tax deduction if a Canadian resident donates U.S. property to a U.S. or Canadian charity. However, this tax relief will no longer be available under the new Protocol. As a result, a Canadian decedent who donates U.S. assets can avoid U.S. estate tax only if the U.S. property is donated to a U.S. charity. This restriction does not apply if the Canadian resident is a U.S. citizen.

Under the fifth Protocol, Canadian-resident decedents that choose to make charitable donations to U.S. charities may elect the value of the gift for purposes of determining the proceeds of disposition of the donated property. The elected price cannot be lower than the purchase price or higher than the fair market value of the property. This provides the estate with the opportunity to eliminate Canadian capital gains taxation on the donated property.

### Taxes Imposed at Death on RRSPs and RRIFs

**Canadian residents:** Canadian-resident decedents who die owning U.S. securities in an RRSP or RRIF may be subject to U.S. estate tax. The new Protocol allows Canadian-resident decedents to claim a foreign tax credit on their Canadian terminal income tax return for U.S. estate taxes paid on the fair market value of U.S. investments in their RRSP or RRIF. The foreign tax credit is limited to the amount of Canadian federal income tax. To claim the foreign tax credit, Canadian income tax must be triggered on the date of the decedent's death. As a result, no foreign tax credit relief is available if the RRSP or RRIF is transferred to a surviving spouse on a rollover basis.

**U.S. citizens/residents:** U.S.-citizen or U.S.-resident decedents may be subject to both U.S. estate tax and Canadian income tax if they die owning an RRSP or RRIF. The new Protocol allows U.S. decedents to claim a foreign tax credit on their U.S. estate tax return for Canadian income tax paid as a result of the deemed disposition of the RRSP or RRIF.

## Taxes Imposed at Death on U.S. Stock Options

The new Protocol confirms that Article XXIX-B provides relief from double taxation when a Canadian resident owns U.S. stock options at death. It is not uncommon for Canadian-resident employees to be granted options to acquire shares of a U.S. public company. Upon death the Canadian resident may be subject to U.S. estate tax on the value of the U.S. options if the value of the U.S. stock exceeds the exercise price. In addition, the decedent may be subject to Canadian income tax as

a result of the deemed disposition of the option. Paragraph 6 of Article XXIX-B provides that Canadian federal tax payable as a result of the deemed disposition of the options will be reduced by the amount of U.S. estate tax paid on the U.S. options.

## For More Information

If you have any questions about the effect of these changes on your estate plan, please contact your PricewaterhouseCoopers advisor or any of the following individuals.

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