

Estate Tax Update

The Departing Canadian (Revised Edition, April 4, 2011)

U.S. estate, gift and generation-skipping transfer tax exposure for Canadians transferred to the United States.

April 4, 2011

A Canadian individual¹ who is transferred to the United States may be exposed to U.S. estate, gift, or generation-skipping transfer tax (collectively, transfer taxes). The exposure depends on whether the individual is regarded for transfer tax purposes as a U.S. resident or a non-resident alien. Criteria for determining residency for U.S. transfer taxes are different from those used for determining residency for U.S. income taxes.

Key aspects of transfer taxes are discussed below and summarized in **Table 3** on page 6. All dollar amounts are in U.S. currency.

U.S. Residents

An individual will be considered a U.S. resident for transfer tax purposes if he or she is domiciled in the United States. A person acquires domicile in the United States by:

- being physically present in the United States, however briefly; and
- forming the intent to reside in the United States permanently.

Domicile is a subjective test because it depends on an individual's intent to remain in the United States. Courts and commentators have developed some objective criteria to help determine whether the intent necessary to establish domicile is present. These criteria include:

- duration of stay in the United States and frequency of travel outside of the United States;
- size, nature and location of residence in the United States, compared to non-U.S. residences;
- location of family, friends, social and business ties;
- location of personal possessions, business interests, voter registration, automobile and driver's licence registration, bank and brokerage accounts, and club and religious memberships; and
- U.S. immigration status.²

A Canadian individual who becomes domiciled in the United States will be subject to U.S. transfer taxes as follows:

- **Estate tax** – on the value of worldwide assets owned at the time of death. The individual is entitled to a lifetime estate tax exemption of \$5 million (unified with the gift tax exemption), so U.S. estate tax is payable only if the individual's estate is valued at more than \$5 million.

1. This *Estate Tax Update* assumes that the Canadian individual being transferred is not a U.S. citizen.
2. While immigration status is relevant, a temporary non-immigrant visa does not necessarily preclude an individual from being considered domiciled in the United States. An individual with certain ties to Canada who is in the United States on a non-immigrant visa that can be renewed annually and indefinitely can still develop the subjective intent to remain in the United States permanently and therefore establish domicile.

- **Gift tax** – on gifts of any property exceeding \$13,000 (the exclusion amount) per recipient, per year. This increases to \$136,000 for 2011 (indexed annually) if the gift is made to a non-U.S. citizen spouse. In addition, the individual is entitled to a lifetime gift tax exemption of \$5 million (unified with the estate tax exemption). However, using the lifetime gift tax exemption reduces the estate tax exemption by a corresponding amount.
- **Generation-skipping transfer tax (GST)** – on gifts of any property to an individual more than one generation younger than the transferor (e.g., from a grandparent to a grandchild). GST tax is imposed at a rate of 35% and is in addition to any applicable gift or estate taxes. The individual is entitled to a lifetime GST exemption of \$5 million.

Temporary Transfers

An individual who is transferred to the United States on a temporary work assignment may not be viewed as domiciled in the United States for U.S. transfer tax purposes, because the individual will not have the intent to permanently reside in the United States. However, if the individual has cut sufficient ties with Canada, he or she will be viewed as a resident of the United States (and a non-resident of Canada) for income tax purposes under the residency rules in the Canada-U.S. Tax Treaty (the Treaty).

This could have significant implications in respect of individuals who die owning U.S. assets while on a temporary work assignment in the United States because, for U.S. transfer tax purposes, an individual on a temporary work assignment in the United States who ceases Canadian income tax residency will not

qualify for certain estate tax Treaty benefits, such as the enhanced unified credit. Conversely, an individual who retains his or her Canadian residency status while on a temporary U.S. work assignment is entitled to take advantage of Treaty benefits such as the enhanced unified credit (see “Unified credit” below).

Non-Resident Aliens

An individual who does not become domiciled in the United States will continue to be considered a non-resident alien for U.S. transfer tax purposes, and therefore will be subject to U.S. estate, gift and GST tax as if still a Canadian resident, as follows:

- **Estate tax** – on the value of “U.S. situs” property owned at the time of death. U.S. situs property includes such things as U.S. real estate, U.S. business assets, shares and options of U.S. corporations and certain debt obligations of U.S. persons.
- **Gift tax** – on gifts of U.S. real estate or tangible personal property (e.g., furniture, jewellery, cash) located in the United States, exceeding \$13,000 per recipient, per year.
- **GST tax** – on gifts of U.S. real estate or tangible personal property (e.g., furniture, jewellery, cash) located in the United States to an individual more than one generation younger than the transferor.

Rates and Exemptions

The U.S. estate and gift tax rates, exemptions, and corresponding credits are illustrated in the following table. Under new legislation, estate tax rates start at 18% and reach 35% for assets worth more than \$500,000. These rates apply through 2012. Unless new legislation is enacted, commencing 2013 the United States will return to the 2001 estate tax rates and exemption.

Table 1: U.S. Estate and Gift Tax Rates, Exemptions and Corresponding Credits

	Highest estate and gift tax rates	U.S. residents (and citizens)			Non-resident aliens			
		Estate tax	Gift tax	GST tax	Estate tax	Gift tax	GST tax	
		Unified Credit	Lifetime Exemption		Unified Credit ²	Lifetime Exemption		
2010 ³ to 2012	35%	\$1,730,800	\$5 million ¹	\$5 million	\$13,000	\$60,000	\$0	\$0
2013	55% ⁴	\$345,800	\$1 million ¹	\$1 million	\$13,000	\$60,000	\$0	\$0

1. Use of the lifetime gift tax exemption will decrease the estate tax exemption by a corresponding amount.

2. May be increased under the Treaty, as discussed on page 3, under “Unified credit.”

3. For 2010, executors of an estate can elect not to pay estate tax and instead apply the modified carryover basis.

4. Tax rate increases to 60% on the portion of the estate between \$10,000,000 and \$17,184,000.

Special Transfer Tax Credits, Exemptions and Deductions

Unified credit

As indicated above, for 2010, U.S. residents (and citizens) are entitled to a U.S. estate tax unified credit of \$1,730,800, which essentially exempts \$5 million of property from estate tax.

Non-resident aliens are entitled to a U.S. estate tax unified credit of \$13,000, which exempts \$60,000 of property from estate tax. However, the Treaty allows a Canadian resident to claim an “enhanced unified credit” that may exceed the \$13,000 credit allowed under U.S. domestic law. The enhanced unified credit is calculated as:

$$\text{U.S. estate tax unified credit} \quad \times \quad \frac{\text{Value of U.S. situs assets}}{\text{Value of worldwide assets}}$$

(\$1,730,800 in 2010)

Consider the following example: Claudio is a Canadian resident and a non-resident alien for U.S. transfer tax purposes. He owns a Florida condominium worth \$1,250,000. The gross value of Claudio’s worldwide estate at the time of his death in 2011 is \$5 million. Because his U.S. assets constitute 25% of his worldwide estate, he will be entitled to claim a unified credit of \$432,700 (25% of \$1,730,800) on his U.S. estate tax return. The gross estate tax arising on Claudio’s condominium will be \$418,300. In the end, Claudio’s estate will not pay any estate tax, because his unified credit of \$432,700 will be sufficient to eliminate his estate tax liability.

As discussed earlier, benefits under the Treaty, such as the enhanced unified credit, are available to an individual only if he or she is a resident of Canada (as determined under the Treaty residency rules).

Therefore, in the above example, if Claudio had been on assignment in the United States at the time of his death, and no longer considered to be a resident of Canada for income tax purposes, he would have been limited to the \$13,000 unified credit. As a non-resident of Canada, he would not qualify for the enhanced unified credit under the Treaty and therefore, his estate tax liability for the condominium would now be \$405,300 (\$418,300 estate tax less the \$13,000 unified credit).

Marital transfers

U.S. citizen spouse

An unlimited marital deduction applies for both U.S. gift and estate tax purposes for gifts or bequests made to a U.S. citizen spouse. In other words, no gift tax is imposed on gifts made to a U.S. citizen spouse during his or her lifetime and no estate tax is imposed on bequests made to a U.S. citizen spouse at death.

Non-U.S. citizen spouse

- **Gift tax** – If the recipient spouse is not a U.S. citizen, the marital deduction is limited to \$136,000 per year (for 2011, indexed annually for inflation). For example, in 2011, a Canadian individual who gives a Florida home worth \$500,000 to his or her non-U.S. citizen spouse will be subject to gift tax on a gift of \$364,000 (\$500,000 less \$136,000).
- **Estate tax** – If the recipient spouse is not a U.S. citizen, the marital deduction is not available unless the bequest is made to a special form of trust known as a Qualified Domestic Trust (QDOT). For a trust to qualify as a QDOT:
 - the surviving spouse must receive the income from the trust at least annually;
 - no person other than the surviving spouse can be a beneficiary during the spouse’s lifetime; and
 - at least one trustee must be a U.S. individual, U.S. bank or U.S. trust company.
 If the QDOT is funded with more than \$2 million, the trustees must file a bond or letter of credit with the IRS, unless at least one trustee is a U.S. bank or U.S. trust company. Estate tax is imposed at the earlier of the distribution of trust principal to the surviving spouse, or the death of the surviving spouse.

Marital credit

If the marital deduction is not available, the Treaty provides a marital credit against estate tax when property is transferred to a surviving non-U.S. citizen spouse. For this credit to be available, certain conditions must be met, but it can be claimed even if the deceased and his or her spouse are both residing in the United States at the time of death (if at least one spouse is a citizen of Canada).

U.S. Estate Tax Example – Resident vs. Non-Resident Alien

In 2008, Diane, a Canadian citizen, was transferred from Canada to the United States by her employer. Diane dies in 2011, leaving all of her assets to her spouse who is not a U.S. citizen. At the time of her death, Diane's worldwide estate is valued at \$10 million, which includes a \$2 million U.S. home.

If the assignment was temporary, and Diane intended to return to Canada at the end of her assignment, she likely would not be considered domiciled in the United States at death. However, if Diane was transferred to the United States on a permanent assignment, and had no intention of returning to Canada, she might be considered domiciled in the United States at death.

The following table shows that if Diane is considered domiciled in the United States, she will have a small estate tax liability after the applicable credits. However, if Diane transfers on a temporary assignment, and is not domiciled in the United States (but is a resident of the United States for income tax purposes under the Treaty), she will be subject to U.S. estate tax on her U.S. situs assets.

Table 2: U.S. Estate Tax Example – Resident vs. Non-Resident Alien

	Diane's domicile	
	U.S.	Not U.S.
Assets subject to U.S. estate tax	\$10,000,000	\$2,000,000
Gross U.S. estate tax before credits	\$3,480,800	\$680,800
Less: Unified credit	\$1,730,800	\$13,000
Marital credit under Treaty	\$1,730,800 ¹	\$13,000
Net U.S. estate tax	\$19,200	\$654,800

1. The marital credit equals the lesser of the unified credit and the amount of the estate tax.

This example illustrates that an individual who temporarily relocates to the United States should be cautious when considering purchasing U.S. assets because, on death, such assets will be subject to U.S. estate tax, and Treaty relief (via the enhanced unified credit) will not be available if the individual has ceased Canadian residency for Treaty purposes.

Joint Tenants with Right of Survivorship

It is common in Canada for spouses to hold property as joint tenants with right of survivorship. However, joint ownership may cause unintended U.S. transfer tax consequences as follows:

- **Estate tax** – If a surviving spouse is not a U.S. citizen, 100% of jointly-owned property will be includable in the deceased's estate and subject to estate tax, unless:
 - the property is transferred by the surviving spouse to a QDOT; or
 - the surviving spouse can prove that he or she contributed funds towards the purchase of the property.

In some cases it may be best to sever the joint tenancy in order to pursue planning through the individual's will.
- **Gift tax** – for real property purchased after July 13, 1988, and certain bank and brokerage accounts, there may be a gift upon the termination of the joint property interest.

Insurance Proceeds

In Canada, insurance proceeds are received by the beneficiary tax free. However, insurance proceeds will affect a Canadian's U.S. estate tax as follows:

- **U.S. resident (domiciled in the U.S.) at the time of death** – The value of any insurance policies on the decedent's life that the decedent either owned or possessed "incidents of ownership" will be included in the decedent's worldwide estate at death, and subject to U.S. estate tax.
- **Non-resident alien (not domiciled in the U.S.) at the time of death** – The value of any insurance proceeds on the decedent's life are not considered U.S. situs property and are not subject to U.S. estate tax.³ However, the insurance will be included in the decedent's worldwide estate for purposes of determining the enhanced unified credit under the Treaty. Therefore, insurance proceeds could significantly reduce the enhanced unified and marital credits available to the deceased taxpayer.

3. The cash value of a policy, underwritten by a U.S. insurer on the life of another person, that is owned by a non-resident alien is considered to be U.S. situs property.

To protect the insurance proceeds from U.S. estate tax, it may be beneficial to hold the insurance in an insurance trust.

Canadian Wills

Canadians who are transferred to the United States should ensure that their existing Canadian wills operate effectively from both Canadian and U.S. tax perspectives. To determine this, they may want to seek advice from competent counsel in the state in which they will be residing.

Planning Points for Temporary Transfers

An individual who is transferred to the United States on a temporary work assignment may want to consider the following planning points:

- **Life insurance** – Term life insurance can fund the individual's current U.S. estate tax liability. This is a flexible planning option, considering the uncertainty surrounding the U.S. estate tax regime beyond 2012. A cost-benefit analysis should be done, based on the individual's personal circumstances, and the individual should consider the issues discussed on page 4 under "Insurance Proceeds."
- **Ownership of U.S. assets** – The individual should limit personal ownership of U.S. situs assets. For example, he or she may want to consider renting instead of purchasing a U.S. home, if it makes sense in the individual's personal circumstances.
- **Acquiring a U.S. green card** – The individual should consider the effect that acquiring a U.S. green card could have on his or her U.S. domicile status, because possession of a U.S. green card indicates an intention of permanent U.S. residence.

- **Will planning** – The individual should have a current will that has been reviewed by U.S. and Canadian advisers to ensure that it operates effectively from the tax perspectives of both countries.

Permanent Transfers

If an individual's U.S. assignment changes from temporary to permanent in nature, the individual's domicile may also change because the individual is now intending to reside in the United States on a permanent basis. As a person with U.S. domicile, the individual will be subject to U.S. estate tax on worldwide assets and will receive the estate tax unified credit that a U.S. person receives. The individual should review the planning that has been implemented to ensure that it continues to make sense from a U.S. estate tax perspective, based on his or her domicile. In addition, it may be beneficial to undertake a gifting strategy before becoming domiciled in the United States, to avoid the application of U.S. gift tax.

Long-Term U.S. Residents (Green Card Holders)

Certain long-term residents are subject to the U.S. expatriation rules when they cease U.S. residency. These rules may apply if the individual held a U.S. green card in at least eight of the fifteen years ending with the year of expatriation. The expatriation rules contain gift tax provisions that may apply after the date of expatriation to gifts or bequests made to U.S. persons. These rules should be reviewed in detail before the individual terminates U.S. residency.

Table 3: U.S. Transfer Tax Summary for the Departing Canadian

		Canadian domiciled in the United States (U.S. resident)	Canadian not domiciled in the United States (Non-resident alien)
Estate tax		On worldwide estate	On U.S. situs property only
Gift tax		On gifts of all property	On gifts of U.S. real estate or U.S. tangible personal property ¹
GST tax		On generation-skipping transfers that are subject to either gift tax or estate tax	
2011 lifetime exemption	Estate tax	\$5 million	\$60,000
	Gift tax	\$5 million	\$0
	GST tax	\$5 million	\$0
2011 enhanced unified credit (under the Treaty)		Not applicable	<ul style="list-style-type: none"> • \$1,730,800 x U.S. situs assets/worldwide assets (for Canadian residents) • Available only for individuals who are residents of Canada under the Treaty – if not resident in Canada, the credit is limited to \$13,000
Marital deduction		Transfer to U.S. citizen spouse: unlimited marital deduction for gift and estate tax Transfer to non-U.S. citizen spouse: \$136,000 annual marital deduction for gift tax (but no marital deduction for estate tax unless assets are left to a QDOT)	
Marital credit (Under the Treaty)		Can claim against estate tax for transfers to a non-U.S. citizen spouse (if deceased's estate waives the right to claim a marital deduction and certain residency/citizenship conditions are met)	
Insurance proceeds		Subject to U.S. estate tax	Not subject to U.S. estate tax (but will be includable in the worldwide estate in determining the enhanced unified credit under the Treaty)

1. Certain long-term residents of the United States may be subject to the U.S. expatriation transfer tax rules. A long-term resident of the United States is defined to be a lawful U.S. permanent resident (U.S. green card holder filing as a U.S. resident) in at least eight of the fifteen years ending with the taxable year of expatriation. These rules may subject the U.S. recipients of gifts to U.S. gift tax in certain circumstances.

For More Information

U.S. transfer tax implications can arise from an employment transfer to the United States. However, with proper planning, individuals and their families can minimize their exposure to these taxes, and preserve their wealth. For more information, please call or email us.

Greater Toronto Area (including Hamilton)	Beth Webel	905 972 4117	beth.webel@ca.pwc.com
	Nadja Ibrahim	403 509 7538	nadja.ibrahim@ca.pwc.com
Calgary		(toll-free) 1 877 453 6448 ext. 7538	
	Chris Gandhu	403 509 6615	christopher.s.gandhu@ca.pwc.com
Edmonton	James Merkosky	780 441 6858	james.d.merkosky@ca.pwc.com
London	Paul Coulter	519 640 7922	paul.coulter@ca.pwc.com
Maritimes	Dean Landry	902 491 7437	dean.landry@ca.pwc.com
Montreal	Julie Doyon	514 205 5263	julie.doyon@ca.pwc.com
		(toll-free) 1 877 374 9065 ext. 5073	
Ottawa	Lois McCarron-McGuire	613 755 4345	lois.a.mccarron-mcguire@ca.pwc.com
Quebec City	Martin O. Boiteau	418 691 2473	martin.o.boiteau@ca.pwc.com
Saskatoon	Frank Baldry	306 668 5910	frank.m.baldry@ca.pwc.com
St. John's	Allison Saunders	709 722 3889	allison.j.saunders@ca.pwc.com
Vancouver	Pat Blair	604 806 7063	pat.j.blair@ca.pwc.com
Waterloo	Martin Kern	519 570 5711	martin.kern@ca.pwc.com
Windsor	Loris Macor	519 985 8913	loris.macor@ca.pwc.com
Winnipeg	Carol Stockwell	204 926 2449	carol.l.stockwell@ca.pwc.com

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Estate Tax Update

Continued U.S. Estate Tax Uncertainty

Highlights estate tax changes, most of which apply only until December 31, 2012.

January 31, 2011

Temporary U.S. Estate Tax Relief Leaves Future Uncertain

On December 17, 2010, President Obama passed legislation that reinstates estate and generation-skipping taxes for 2010 through 2012. These changes affect:

- U.S. citizens and individuals domiciled in the United States; and
- Canadian citizens and residents who are subject to U.S. estate tax on account of owning U.S. assets (such as U.S. real estate or stock in U.S. corporations) because the relief provided under Article XXIX-B of the Canada-United States Tax Treaty is tied to the U.S. estate tax exemption.

Reinstatement of estate tax

The new legislation retroactively reinstates estate tax with a top tax rate of 35% and a \$5 million exemption (indexed for inflation after 2011). For the estates of individuals who died in 2010, the estate's executor may elect to treat the estate as if the new legislation had not been enacted, in which case, the estate would not be subject to estate tax and the modified carryover basis rules would apply. If no election is made, the estate will be subject to the new estate tax regime, which generally provides for a stepped-up basis in property passing from the decedent. The new legislation also allows the executor of a deceased spouse's estate to transfer any unused portion of the exemption to the surviving U.S. citizen or U.S. resident spouse.

Changes to gift tax

For gifts made in 2010, the gift tax exemption is \$1 million and the tax rate is 35%. Starting in 2011, the legislation increases the gift tax exemption to \$5 million. Any use of the \$5 million exemption towards a gift will reduce the exemption available for estate tax.

Reinstatement of generation-skipping transfer (GST) tax

The new legislation also reinstates GST tax through 2012 for transfers made after December 31, 2009. A top tax rate of 35% and a \$5 million exemption (indexed for inflation after 2011) are provided. Although the GST tax applies retroactively in 2010, the tax rate for any generation-skipping transfer made during the 2010 calendar year will be zero. The GST tax rate will increase to 35% in 2011 and 2012.

Caution required

The attached *Estate Tax Update* assumes that the 2010 estate tax regime changes are in effect. However, the U.S. has not passed legislation that extends the 2010 federal estate tax rate and exemption level beyond December 31, 2012. Unless legislation is passed before the end of 2012, 2013 will see reinstatement of:

- 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 \$17,184,000).