

Estate Tax Update

U.S. Estate Tax Exposure for U.S. Citizens Living in Canada (Revised Edition, February 28, 2011)

The interaction of U.S. and Canadian tax rules can have important implications for U.S. citizens living in Canada.

February 28, 2011

If you are a U.S. citizen living in Canada, you may be subject to both the Canadian and U.S. tax regimes at your death.

As a Canadian resident, you are subject to Canadian income tax at death. As a U.S. citizen, you are subject to U.S. estate tax on the fair market value of your worldwide estate at the time of your death. Your worldwide estate includes all property owned at death – regardless of where the property is located – even:

- life insurance proceeds, if you own the policy or if the proceeds are payable to your estate;
- certain property transferred within three years of death;
- registered plans (e.g., registered pension plans, registered retirement savings plans and registered retirement income funds);
- certain trust interests; and
- stock options.

Are You a U.S. Citizen?

U.S. citizenship status is not always clear. For example, while an individual will be granted U.S. citizenship by virtue of being born in the United States, an individual may also be a U.S. citizen if he or she is born outside of the United States to a parent who is a U.S. citizen. You should consult an immigration lawyer if you are unsure about your status.

U.S. Estate Tax Rates and Lifetime Exemption

In 2011, the U.S. estate tax rate starts at 18% and climbs to 35% when the value of your estate reaches \$US500,000. As a U.S. citizen, you are entitled to a lifetime estate tax exemption. In 2011, the estate tax exemption is \$US5 million, unified with the gift tax exemption. This means that, as long as no portion of the exemption was used towards gift tax, no estate tax is payable if your worldwide estate is valued at less than \$5 million.

Unless new legislation is enacted, the U.S. top tax rate will climb to 55% and the exemption will fall to \$US1 million after December 31, 2012. It is uncertain what future legislation may bring; however it seems prudent to assume that U.S. estate tax will be around in some form beyond 2012.

Foreign Tax Credits

On death, for Canadian income tax purposes, you will be deemed to dispose of your capital assets for an amount equal to their fair market value on the date of death. As a result, you may pay capital gains tax in Canada. In addition, you will be subject to U.S. estate tax on the fair market value of those assets.

The Canada-U.S. Tax Treaty (the Treaty) provides some relief against double taxation in the form of foreign tax credits. Under the Treaty, Canada allows a federal credit for U.S. estate tax payable on your property that is located in the United States. The United States allows a credit for Canadian taxes payable at death on the deemed disposition of your property that is located outside of the United States, as illustrated by the following example:

Evan is an unmarried U.S. citizen living in Canada. At the time of his death, Evan owned a Canadian stock portfolio with a fair market value of CAS100,000, which he purchased for CAS25,000. Evan's estate will be subject to Canadian capital gains tax on the accrued gain of CAS75,000, and also to U.S. estate tax on the CAS100,000 stock portfolio. The Treaty allows Evan to reduce his U.S. estate tax liability by the amount of the Canadian capital gains tax paid on the CAS75,000 accrued gain.

In the end, your estate generally pays the higher of the two taxes. Because Canadian capital gains tax rates are lower than U.S. estate tax rates, your estate will likely pay tax at the U.S. estate tax rate. Moreover, there is an element of double taxation because the foreign tax credit is provided only at the federal level and not the provincial level.

Marital Deduction and Marital Credit

As a Canadian resident, you can transfer your assets to your Canadian-resident spouse on a rollover basis at the time of your death. This allows you to defer the payment of Canadian income tax until the death of your spouse.

For U.S. estate tax purposes, estate tax is deferred only if your assets pass to a U.S.-citizen spouse (referred to as the marital deduction). If your 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).

Alternatively, the Treaty provides a marital credit against estate tax if certain conditions are met, allowing a U.S. citizen to effectively double the amount that can pass to a Canadian spouse free of U.S. estate tax. For example, if Evan died in 2011 with a surviving non-U.S.-citizen spouse, he could leave

almost US\$10 million of assets to his spouse before his estate would be subject to U.S. estate tax (i.e., double the US\$5 million lifetime exemption, discussed above).

Unused Lifetime Exemption

If a married person dies in 2011 or 2012, any portion of the deceased's \$5 million lifetime exemption that he or she did not use may be used by the surviving spouse's estate. To take advantage of this exemption "portability":

- the surviving spouse must be a U.S. citizen; and
- the executor for the estate of the first spouse to die must file an election to transfer the unused exemption to the surviving spouse.

The election must be filed on time even if the estate is not required to file an estate tax return.

Filing an Estate Tax Return

In general, even if no estate tax is due, a U.S. estate tax return must be filed:

- if the value of your worldwide estate exceeds the exemption amount for the year; or
- to elect the transfer of any unused portion of the exemption to the surviving spouse.

The filing deadline for the return is generally nine months after the date of death.¹

U.S. Gift Tax

You cannot avoid U.S. estate tax by giving away your assets during your lifetime because the U.S. imposes a gift tax on lifetime transfers. Newly enacted legislation reunifies the gift tax with estate tax, so that the gift tax is now imposed at the same rate as the estate tax and provides the same \$5 million exemption amount. However, as discussed, if you use the exemption for gift tax, your estate tax exemption will decrease by a corresponding amount. Gift tax applies to gifts of all types of property, regardless of where the property is located.

Gifts to your U.S.-citizen spouse are not subject to gift tax. However, if your spouse is not a U.S. citizen you will be subject to gift tax if your annual gift to your spouse in 2011 is more than US\$136,000 (indexed annually for inflation).

1. An individual who died during 2010 has an extended filing deadline of September 19, 2011.

In addition, you are entitled to an annual exclusion of US\$13,000 (indexed annually for inflation) for gifts made to anyone other than your spouse. For example, if you have four children, you can give up to US\$52,000 to your children in 2011 and not be subject to U.S. gift tax. You will not be required to file a gift tax return and the US\$52,000 gift will not reduce your lifetime gift and estate tax exemption amount.

If you and your spouse are both U.S. citizens, you can double your annual gift limit by agreeing to split your gifts. However, in this case you and your spouse will be required to file a U.S. gift tax return. These rules are illustrated in the following table.

		Annual exclusion
Recipient	U.S. citizen spouse	No gift tax
	Non-U.S. citizen spouse	US\$136,000 ¹
	All other recipients	US\$13,000/recipient ¹

1. Using your annual exclusion does not affect your lifetime gift and estate tax exemption. The annual exclusions are indexed annually.

U.S. Generation-Skipping Transfer (GST) Tax

The new legislation has reinstated the generation-skipping transfer (GST) tax for certain transfers to a “skip person” (i.e., an individual who is in a generation more than one generation younger than the transferor – such as a grandchild). The GST tax rate is 35% and a US\$5 million exemption (indexed for inflation after 2011) is provided. The GST tax is applied to “skip transfers” in addition to any applicable gift tax. This effectively prevents individuals from transferring property to a “skip person” to avoid a generation of estate tax.

The GST tax also may apply if assets are left to a family trust that includes a skip person. For example, it is common in Canada to leave assets in trust for children and grandchildren. In this case, the deceased may have to allocate his or her US\$5 million GST tax exemption to the trust to prevent the application of GST tax, because the assets could pass to a grandchild at some future date.

For More Information

If you have any questions about your U.S. estate, gift and GST tax exposure, please contact us.

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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).

