

Estate Tax Update

U.S. Family Members in the Canadian Family-Owned Business (Revised Edition, March 10, 2011)

Estate and will planning implications for U.S. family members of Canadian family-owned businesses.

March 10, 2011

Are any of your family members U.S. citizens? Do any of your family members live in the U.S.? Do any of your children attend school in the U.S.?

Even if you are not a U.S. citizen, if a member of your family is a U.S. citizen or resident, traditional Canadian wills, as well as estate and tax planning, may not be effective. Consider the following situations in which standard Canadian planning may actually result in significant additional tax.

The Canadian Estate Freeze

If you implemented an estate freeze, some or all of the future growth in your company accrues for the benefit of your family. This is usually achieved by having your spouse and children own shares of your company, either directly or through a family trust. However, if any of these family members is or becomes a U.S. citizen or resident, you may be faced with the following tax consequences:

- A U.S. family member who dies while owning the shares may be subject to U.S. estate tax. In 2011, the highest estate tax rate is 35% and is applied to the value of the shares owned at death that exceed the US\$5 million lifetime exemption. This tax may also apply if the U.S. family member is a beneficiary of a family trust that owns the shares.
- U.S. gift tax may apply if the U.S. family member gives the shares to another person.
- U.S. generation-skipping transfer tax may apply in addition to gift and estate tax if the U.S. family member gives the shares to a person who is more than one generation younger (e.g., grandparent to grandchild).
- The U.S. family member may have to include a share of the company's income in his or her personal income tax return, even if the income has not been distributed from the company. In some cases, an additional tax or interest charge may be applied.
- If the shares are owned by a Canadian family trust, U.S. income tax may apply to distributions from the trust to the U.S. family member, even if the trust has already been taxed in Canada on the income. An additional tax or interest charge may apply if the trust has been accumulating income and capital gains.
- A U.S. family member who sells shares of the company may be subject to U.S. income tax if there is a capital gain on the shares, even if the sale is tax free in Canada because of the CA\$750,000 capital gain exemption. In addition, the U.S. family member may not be able to benefit from the payment of tax-free capital dividends, because these dividends may be fully taxable for U.S. purposes.

Bequests to your U.S. Spouse

In Canada, if you die owning assets with accrued capital gains, you are taxed on the gains unless the assets are left to your spouse or a Canadian-resident spousal trust. As a result, your will likely provides that your assets will transfer to your spouse or a spousal trust.

However, if your spouse is a U.S. citizen and owns the assets at death, he or she will be subject to U.S. estate tax on all of his or her worldwide assets. (The current top U.S. estate tax rate is 35% and is charged on the fair market value of the assets in excess of the US\$5 million lifetime exemption.) The estate tax bill could be significant if your private company shares pass to your U.S.-citizen spouse under the terms of your will. This could result in an unexpected burden for your estate and your family business if your estate does not have enough liquid assets to cover the U.S. estate tax on the private company shares.

If you have life insurance in place to cover your tax liability, you should ensure the insurance is structured so that your U.S. spouse is not viewed as the owner of the insurance. Otherwise, the life insurance proceeds could be subject to U.S. estate tax.

21-Year Trust Planning

A Canadian trust is deemed to sell all of its assets every 21 years. This is now an issue for any Canadian trust you established in the early 1990s to hold your private company shares.

To avoid capital gains tax on the deemed sale, the trust assets are usually distributed to the trust's beneficiaries. Tax-free distribution of assets is available only to beneficiaries living in Canada. Therefore, the trust assets cannot be distributed tax free to a child living in the U.S. In addition, the assets distributed to the U.S. child will form part of his or her U.S. taxable estate for estate tax purposes.

For both of these reasons it may be best to avoid an outright distribution to the U.S. child. Planning should be undertaken well in advance of the 21st anniversary to ensure these issues are addressed properly.

Estate and Will Planning

These are just a few examples of how traditional Canadian estate and tax planning may not achieve your objectives when you have a U.S. family member. Other popular Canadian planning techniques may also trigger unintended tax consequences.

Now is the time to consider estate and will planning strategies that will be effective for you and the current or prospective U.S. family member. If planning already implemented does not take the U.S. family member into account, strategies can be put into place to minimize or remedy any problems. For example, if you have a child attending school in the United States, planning may be implemented before that child decides to become a permanent resident there.

We Can Help

If you have U.S. family members in your Canadian family-owned business, please call or email your PwC adviser or any of the individuals listed below to discuss the estate and will planning implications.

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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).