

## Estate planning for U.S. assets

**This article is only applicable to residents of Canada who are not U.S. citizens and not U.S. green card holders.** The U.S. estate taxes law for non-residents who are U.S. citizens or green card holders is very different.

An increasing number of people who are residents of Canada own properties located in the U.S.; therefore, the need for estate planning for the U.S. assets is more than it has ever been.

### U.S. estate tax and non-residents of the U.S.

U.S. estate tax liability may arise on the death of a non-resident of the U.S. if the deceased owned U.S. situs assets (generally, assets situated in the U.S.). Examples of assets more commonly held by non-residents of the U.S. that may be subject to U.S. estate tax include real property situated in the U.S. (such as vacation homes), U.S. securities, U.S. mutual funds and certain U.S. debt obligations.

The estate tax is levied on the taxable estate of the deceased at graduated rates. The highest tax rate for 2012 is 35 per cent.

Generally, the taxable estate of the deceased is computed by subtracting allowable deductions from the gross estate of the deceased in the U.S. It's interesting to note, according to Internal Revenue Code section 2105(a) which is a part of the subchapter dealing with the "estate of nonresidents not citizens of the U.S.", the proceeds of an insurance policy on the life of a nonresident of the U.S. is not considered a property located within the U.S.

Subject to certain restrictions,<sup>1</sup> the allowable deductions include funeral expenses, administration expenses, claims against the estate, unpaid mortgages and liens, charitable deductions and state death taxes.

The amount of U.S. estate tax payable is reduced by a unified credit. Under the U.S. domestic laws, a unified credit of up to US\$13,000 is allowed to non-residents of the U.S., which effectively exempts US\$60,000 of the U.S. estate. All figures as of 2012.

### Relief under Canada-U.S. tax treaty (for residents of Canada who are not U.S. citizens or green card holders)

#### Increased unified credit / exemption<sup>2</sup>

The unified credit amount is increased from US\$13,000 to the amount available to U.S. citizens, green card holders and U.S. residents. This may exempt an estate up to US\$ 5,120,000 in 2012 – commonly referred to as the exemption amount. Since the worldwide assets of U.S. citizens are subject to U.S. estate tax, and only U.S. situs assets of the non-resident of the U.S. are subject to the U.S. estate tax, the amount of unified credit or exemption that is available to non-residents of the U.S. is prorated. Consequently, the amount of exemption available to a Canadian resident is calculated as follows, and is further reduced by the amount claimed in the past to shelter from any gift tax in the U.S. while the deceased was alive:

Exemption amount X value of U.S. situs assets

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Value of worldwide assets

<sup>1</sup> Please refer IRS publication "Instructions for Form 706-NA" for additional information.

<sup>2</sup> Article XXIX-B(2) of the Canada-U.S. tax treaty

For the purposes of this calculation, the worldwide assets include all assets of the deceased, including those that may not be subject to tax in Canada such as life insurance proceeds, principal residence, etc.

### Small estate provision<sup>3</sup>

At present, this rule may not be of much use as the unified credit available to Canadian decedent may be as high as US\$5.12 million (2012 exemption amount). However, it may become useful if the unified tax credit is reduced below US\$1.2 million.

This provision provides that if the entire gross estate of the Canadian resident decedent does not exceed US\$1.2 million, the U.S. may impose estate tax upon the property forming part of the estate only if the gain on sale of the property would have been subject to U.S. income taxation under Article XIII (Gains) of the Canada-U.S. tax treaty.

The effect of this provision is a relief to the Canadian resident decedents who held assets such as a portfolio of U.S. securities and otherwise did not have a large worldwide estate. However, any U.S. real property does not qualify for this relief, as the gain on sale of the U.S. real property is subject to U.S. income tax.

### Marital tax credit<sup>4</sup>

In addition to the unified credit, the estate of the Canadian resident decedent may be eligible for a marital tax credit, subject to meeting certain conditions. The credit is equal to the lesser of the amount of unified credit allowed or the amount of estate tax that would otherwise be payable on property transferred to the deceased's spouse.

### Canadian foreign tax credit

<sup>3</sup> Article XXIX-B(8) of the Canada-U.S. tax treaty

<sup>4</sup> Article XXIX-B(3) & (4) of the Canada-U.S. tax treaty

The U.S. estate tax payable on the death of the Canadian resident individual may be applied against the Canadian federal income tax in the year of death on U.S. source income. Depending on the circumstances of the deceased, the credit for U.S. estate tax may be limited. The credit may not be available against provincial taxes.

### Planning tips

The following are some tips that may help to reduce the U.S. estate tax liability or help fund the U.S. tax liability.

#### Do not become U.S. citizen, green card holder or resident

It may be helpful if the individual does not become a citizen, green card holder or resident of the U.S. For estate tax purposes, a resident is someone who had a domicile in the U.S. at the time of death. A person acquires a domicile by living in a place for even a brief period of time, as long as the person had no intention of moving from that place.

#### Hold U.S. assets through a Canadian corporation

An individual could consider acquiring U.S. property using a Canadian resident corporation. However, the Canada Revenue Agency may assess a taxable shareholder benefit for the use of the property by the shareholder or person related to the shareholder.

#### Non-recourse mortgage

Generally, the debts/liabilities of the deceased are prorated between the U.S. and non-U.S. assets in allowing deductions from the gross estate to determine the taxable estate for U.S. estate tax purposes. However, if a U.S. real property is financed through a non-recourse mortgage, the entire mortgage amount is allocated against the value of the U.S. real property without any proration. This may help

significantly reduce the value of U.S. situs assets and resulting estate tax.

## Reduce non-U.S. estate

Reduction in the non-U.S. estate increases the prorated amount of unified credit and reduces U.S. estate tax. An individual should consult a tax expert to determine if establishing a trust for assets or for inheritances to be received, direct transfer of assets to children/spouse, and donation of stocks to a charity while alive instead of through a will, etc. can be used in specific circumstances to reduce non-U.S. assets.

## Non-U.S. mutual fund

Instead of investing directly in U.S. securities, an individual might consider buying non-U.S. mutual funds that hold U.S. securities. Non-U.S. mutual funds are not considered U.S. situs property.

## Rent, rather than buy

Individuals could rent rather than buy U.S. vacation and other personal properties such as boats, automobiles, etc. This may help reduce insurance and maintenance costs too.

## Decide who should buy U.S. assets

The spouse with lower worldwide assets should buy the U.S. assets to increase the unified credit. Similarly, the younger spouse should buy the U.S. property to possibly lengthen the time before U.S. estate tax becomes payable. If there's consideration to provide funds to a spouse to purchase the property, before implementing this strategy, the individual should discuss with a tax advisor the possible application of Canadian attribution rules, and if it will be possible to deduct the foreign taxes paid by the spouse, as no foreign tax credit may be available.

## Avoid joint tenancy in U.S. assets

In the case of spousal joint tenancy where the surviving spouse is not a U.S. citizen, the entire value of the property is included in the estate, unless it can be proven that the property was not entirely funded by the deceased. The property will be subject to estate tax again when the surviving spouse dies. Thus, joint tenancy may create the possibility of double taxation. It may also create a foreign tax credit issue in Canada. This is because, for Canadian tax purposes, the property jointly owned by the spouses usually passes tax-deferred to the surviving spouse, and consequently, there is no Canadian income inclusion on the death of first spouse. As mentioned earlier, consider the impact of Canadian attribution rules, possibility of the deduction of foreign taxes paid by the spouse, and no credit for foreign taxes paid by the spouse.

## Other methods

Some other methods are to hold U.S. assets through a trust, partnership, or U.S. qualified domestic trust. However, these methods are complicated and like the other methods discussed require the help of a professional during set-up and on an on-going basis.

## The simple solution – life insurance

If the above solutions are overwhelming or not practical in a particular circumstance, the simple solution could be to purchase a Canadian life insurance policy to fund the impending U.S. estate tax liability.

A Canadian resident owner of the U.S. assets purchases a Canadian life insurance policy on his/her life and the estate is designated as beneficiary. The death benefit (generally not subject to Canadian income tax<sup>5</sup>), will be received by the estate of the deceased owner and can be used to pay the U.S. estate tax liability.

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<sup>5</sup> May be subject to probate tax

The life insurance proceeds are included in the worldwide assets, and therefore, reduce the prorated amount of the unified credit. It may also increase the value of the estate over the small estate limit thus eliminating that source of relief. However, the receipt of income tax-free funds just in time may more than offset the reduction in unified credit, and may also prove to be an attractive tool for estate planning and equalization purposes.

## Important notes

This article outlines the situation as of 2012. The current U.S. estate tax law expires at the end of 2012. If no action is taken before the end of 2012 the estate tax rate and limits will return to the levels which existed in 2001 which would significantly increase the tax payable.

U.S. estate taxation of individuals who are not U.S. residents is complex. You should obtain advice from advisors who have the required expertise before taking any action.