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U.S. Taxes for Canadians with U.S. assets

U.S. Gift, Estate and Generation Skipping Transfer Tax can affect Canadians who don't even live in the United States. This article examines how these taxes may affect Canadians, and some strategies for dealing with them.

Introduction

Few countries seem more alike than Canada and the United States, and few countries have shared the same friendly relations that Canada and the United States have enjoyed for so long. As a result, many citizens and companies from both countries have crossed the border to live, work, invest and do business. One result of this relatively easy access to the other country is that many Canadians may find themselves unexpectedly subject to the U.S. tax system.

For example, Canadians may be subject to U.S. taxes on transfers of U.S. property, such as gift taxes while they're alive, estate taxes on their deaths, or Generation Skipping Transfer Tax (GSTT) if they transfer property to grandchildren or great grandchildren. This bulletin deals with some of the transfer tax issues that Canadians may face if they own U.S. assets.

U.S. gift tax

The Internal Revenue Code (IRC) taxes transfers of property where the donor doesn't expect "to receive something of at least equal value in return."[1] The tax applies to pure gifts, where the donor receives nothing in return, and to partial gifts, where the donor receives something of less value than what they gave.

Gift and estate tax applies to three classes of people:

1. U.S. citizens, regardless of their residency
2. U.S. residents, regardless of their citizenship
3. Anyone who owns "U.S. situs property", regardless of their residency or citizenship

[1] IRS Publication 559, "Survivors, Executors and Administrators," January 31, 2014, at http://www.irs.gov/pub/irs-pdf/p559.pdf.

The definition of U.S. situs property differs for gift and estate tax purposes. For gift tax purposes it includes real estate located in the U.S., like vacation homes, and tangible assets located in the U.S., like a car licensed and garaged in the U.S. (IRC §2511(a)).

U.S. situs property for gift tax purposes doesn't include intangible assets like U.S. stocks, bonds, mutual funds, or bank, brokerage and trust accounts, even if the custodians for those assets and accounts are located in the U.S. (IRC §2501(a)(2)).

There are exemptions to the gift tax rules. There is no gift tax on gifts the donor makes to:

- their U.S. citizen spouse (IRC §2523(a))
- their non-citizen spouse up to US$147,000 annually (IRC §2523(i))[2]
- anyone else up to $14,000 per recipient annually (IRC §2503(b))[3]

Gifts that exceed the $147,000 and $14,000 limits are called taxable gifts; those within the limits aren't taxable. The gift tax exemptions apply only to gifts of a "present interest", meaning that the recipient must be able to use the gift immediately on receiving it (IRC §2503(b)).

Gift and estate tax rates are the same, starting at 18% and rising to a 40% top rate. The top rate applies to gifts made during life and at death of more than $1 million (IRC §2001(c)). The calculation of gift tax is cumulative, and forces individuals to include prior year gifts in the tax calculation for current gifts. Including prior year gifts in the tax calculation forces the taxation of current and future gifts to occur at higher rates. Essentially, prior gifts permanently occupy the lower rungs of the tax ladder, leaving only the higher rungs for current and future gifts. If the value of all the gifts an individual has made over their lifetime exceeds $1 million, future gifts and transfers at death will be taxed at the 40% rate.

A tax credit, called the unified credit, lets American citizens and residents eliminate or reduce gift and estate tax. The credit is indexed to the rate of inflation. For 2015 the credit eliminates up to $2,113,800 in tax, allowing a U.S. citizen or resident to pass up to $5.43 million in wealth tax-free during life or at death. If they use the unified credit to shelter gifts made in earlier years, that amount of the credit isn't available in later years. And if they use the unified credit to eliminate gift tax, the credit isn't available to reduce or eliminate estate tax. If, for example, someone dying in 2015 had made taxable lifetime gifts exceeding $5.43 million, their taxable estate would be subject to a 40% tax with no unified credit available to reduce any of that tax.

As we will discuss below, the Canada-U.S. Tax Treaty (the Treaty) gives Canadian citizen/residents access to the unified credit for estate tax purposes in the same proportion that their U.S. situs assets bears to their world-wide assets.

Capital gains and gifts

U.S. gift tax rules can cause problems when a Canadian makes a gift of U.S. situs property with unrealized capital gains. Generally under U.S. gift tax law, if a donor gives property with unrealized capital gains the donor doesn't have to treat the gift as a disposition, and doesn't have to include the capital gain in income. Instead, the recipient acquires the property with the same adjusted cost base in the asset (so with the same latent capital gains tax liability) as the donor (IRC §1015). When the recipient sells the asset they'll pay capital gains tax on growth that occurred while they and the donor owned the gifted asset. Canada, on the other hand, generally deems a gift to be a transfer that forces the donor to realize the capital gain on the asset when the gift is made. Because different people are paying capital gains tax at different times, there's a potential for double taxation on that part of the capital gain accumulated while the donor owned the asset.

To address this problem, Article XIII-7 of the Treaty lets the donor elect to be treated as if they had sold and repurchased the asset just before giving it. This election accelerates realization of the capital gain for U.S. tax purposes. It results in the donor having to pay U.S. and Canadian capital gains tax on the gains accumulated to the time the gift was made. But a Canadian taxpayer may use foreign tax credits to eliminate or reduce any double taxation that may result. When the recipient disposes of the asset, they pay capital gains tax only on the gains accumulated while they owned the asset.

[2] 2015 limit, indexed to inflation. All amounts are expressed in U.S. dollars unless noted otherwise.
[3] 2015 limit, indexed to inflation.

However, a double tax issue remains, which the Treaty does not address. A donor could pay U.S. gift tax and Canadian capital gains tax without any foreign tax credit available to reduce the double taxation. The Treaty addresses this double tax issue in the sections that deal with property transfers at death, but not during life.

U.S. estate tax

The U.S. levies an estate tax, calculated on the fair market value of all property the deceased passed at death, with deductions for items like debts, funeral costs, final medical expenses and charitable donations. The tax rate is the same as discussed above on gifts. U.S. citizens and residents may use the unified credit to reduce or eliminate their exposure to this tax. The size of the credit is the same, and any part of the credit used to reduce or eliminate gift tax will be unavailable to reduce or eliminate estate tax.

Those who are not U.S. citizens or residents are subject to U.S. estate tax only on the value of their U.S. situs assets (IRC §2103). An important difference between gift and estate tax is that the definition of U.S. situs assets includes intangible assets, like the following:

- Shares in U.S. corporations (IRC §2104). This rule catches shares in U.S. corporations that the deceased owned outright or in a brokerage account, and shares owned in the deceased's RRSP. But it doesn't apply to mutual funds the deceased owned, even if the mutual fund owned shares in U.S. corporations, regardless of whether the mutual fund is an RRSP, a RRIF or is non-registered.[4]
- U.S. pension plans like 401(k) plans and Individual Retirement Accounts (IRAs).
- Transfers of U.S. situs property made within 3 years of death (IRC §2104(b)).
- Debt obligations issued by a person, institution or government (federal, state or municipal) of the United States (IRC §2104(c)).

Some intangible assets are exempt from inclusion in the non-resident's estate, including:

- Life insurance death benefits paid on the death of a non-resident/non-citizen (IRC §2105(a)).
- Bank deposits and money earning interest held by life insurance companies, where the interest earned isn't effectively connected with a trade or business carried on in the United States (IRC §2105(b)).

An important feature of the estate tax for Canadians is that U.S. situs assets owned jointly with right of survivorship are included in the estate at full value when the deceased joint owner isn't a U.S. citizen.

A non-resident/non-citizen is entitled to a $13,000 estate tax credit, which exempts their estates from estate tax on up to $60,000 in U.S. situs assets (IRC §2102(b)), and exempts their executor from having to file a U.S. estate tax return.[5] However, there may be reasons for filing a return anyway, like locking in date-of-death fair market values for estate assets. Executors should speak with their tax and legal advisors about whether they should file a return when the deceased's U.S. situs assets are below the $60,000 threshold.

If the value of a Canadian citizen/resident's U.S. situs assets exceeds $60,000, their executor will need to file an estate tax return. But the estate may not have to pay estate tax, depending on the value that the deceased's world-wide assets bears to their U.S. situs assets, on who receives those assets, and on the provisions of the Treaty. Under the Treaty, Canadians with an exposure to U.S. estate tax may be able to partly benefit from the unified credit available to U.S. citizens. The credit is based on the value that the deceased's U.S. situs assets bears to the value of their worldwide estate. For example, if 50% of the value of a Canadian's assets were U.S. situs assets, only 50% of the credit would be available (Treaty, XXIX B-2).

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[4] IRS Chief Counsel Memorandum 201003013, dated January 22, 2010, at http://www.irs.gov/pub/irs-wd/1003013.pdf. This guidance may also apply to registered retirement income funds (RRIFs) though RRIFs weren't discussed.

[5] See Instructions to IRS Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return – Estate of nonresident not a citizen of the United States, "Who Must File".

Example:
To better understand the impact of the U.S. estate tax on a Canadian citizen/resident, let's look at the following example of a Canadian leaving an estate in 2015 worth $7,000,000:[6]

U.S.-situs assets	Fair market value on date of death
Shares of U.S. corporations	$1,340,000
Condominium in Florida	$600,000
Boat in Florida	$60,000
Total	**$2,000,000**

Non-U.S. world-wide assets	Fair market value on date of death
House	$960,000
Household furnishings	$25,000
Vehicles	$65,000
Rental properties	$700,000
Non-registered Canadian equity mutual fund	$450,000
Non-registered Canadian stock and bond portfolio	$700,000
Cash and cash equivalents	$100,000
Life insurance policy death benefit	$1,000,000
Present value of defined benefit survivor's pension	$1,000,000
Total	**$5,000,000**
Total asset value (U.S. situs and world-wide)	**$7,000,000**

The Treaty requires a Canadian to calculate their world-wide estate according to U.S. estate tax rules (Treaty, XXIX B-2). This produces results that may surprise many Canadians. For example, life insurance death benefits on policies the individual personally owns on their own life are included as estate assets, even if the death benefit isn't payable to the estate. And the present value of the income to a survivor from a deceased's pension or annuity is also included as an estate asset. An estate's value for U.S. estate tax purposes is generally the value of what other people receive from the deceased, not necessarily what the deceased owned just before death. The estate's value may be more than the deceased's net worth immediately before death.

U.S. estate tax on U.S. situs assets	Tax
Tentative estate tax on first $1,000,000	$345,800
Tentative estate tax on remaining $1,000,000 at 40%	$400,000
Total tentative estate tax	**$745,800**
Prorated unified credit ($2,113,800 x ($2,000,000 / $7,000,000)	$603,943
U.S. estate tax payable	**$141,857**

If any part of the estate is left to the deceased's spouse (also a Canadian citizen and resident), an additional marital estate tax credit is available under the Treaty (Treaty, XXIX B-3). The credit is the lesser of the prorated unified credit ($603,943 in this case) and the amount of estate tax assessed ($141,857). In this case the credit eliminates estate tax on the death of the first spouse. When the second spouse dies, there may still be an estate tax issue, depending on whether that spouse still owns any U.S. situs assets.

The tax result is different for a U.S. citizen or resident:

U.S. estate tax on world-wide assets	Tax
Tentative estate tax on first $1,000,000	$345,800
Tentative estate tax on remaining $6,000,000 at 40%	$2,400,000
Total tentative estate tax	**$2,745,800**
Unified credit	$2,113,800
US estate tax payable	**$632,000**

[6] The example is simplified, and is an approximation. It assumes that no taxable gifts have been made during the deceased's lifetime. An executor would need to consult with a tax professional when completing an estate tax return.

In the example of a deceased U.S. citizen, if the estate were left entirely to their U.S. citizen spouse, the unlimited marital deduction would apply, eliminating estate tax at the first spouse's death (IRC §§2056 and 2106(a)(3)). On the second spouse's death, that spouse's executor could use both spouses' unified credits to eliminate estate tax at that time. But the unified credit on the first spouse's death can't be adjusted for inflation (IRC §2010(c)(4)).

Relief for small estates

If a Canadian citizen/resident's worldwide estate is worth less than $1.2 million, U.S. estate tax applies only to U.S. situs real property and to personal property that's part of a business in the United States (Treaty, XXIXB-8 and XIII). The tax won't apply to non-business personal property or to intangible property.

Capital gains and estate tax

Just as a Canadian citizen/resident could have a capital gains tax problem with gift tax, they could have a capital gains tax problem with estate tax. Generally, under U.S. estate tax rules the adjusted cost base in capital assets owned at death is increased to fair market value (IRC §1014). This rule deals with the potential for double taxation under the U.S. income and estate tax systems: capital gains are forgiven at death for income tax purposes, but the entire value of the asset may be subject to estate tax. Under Canadian law there's a deemed disposition of all assets at death, with half of any capital gains included in the deceased's final tax return. A U.S. situs asset could therefore be subject to both American estate tax and Canadian capital gains tax.

The Treaty provides some relief. The executor may claim a foreign tax credit. The credit is for any U.S. federal or state estate tax imposed on the disposition of an asset up to the amount of tax payable on its disposition under Canadian law (Treaty, XXIX B-6). Paragraph 6(a)(i) provides a credit for U.S. estate tax on U.S. situs real estate and on personal property used in a business in the U.S. Paragraph 6(a)(ii) provides relief from double taxation arising from all other U.S. situs property when the size of the estate exceeds $1.2 million (calculated according to U.S. law). These provisions dovetail with the provisions in paragraph 8 granting tax relief for small estates.

Some provinces allow a foreign tax credit similar to the federal government's, which could further reduce the estate's Canadian income tax liability, and further reduce the potential for double taxation.

As discussed above, this provision applies to estate tax only. The Treaty doesn't let a donor reduce the amount of gift tax imposed on a gift by the amount of tax payable on its disposition under Canadian law.

State inheritance and death taxes

Many but not all states impose a death tax. Some, like Virginia, impose no death tax of any kind. Others, like Connecticut, impose an estate tax that parallels the federal tax system. Before 2005, for those states that based their death tax on the federal model, federal estate tax law allowed a credit for state death taxes. Many states harmonized their estate tax regimes with the federal regime to use the entire credit. Effectively, state estate taxes were "paid for" with the credit.

After 2005 the federal credit was eliminated in favour of a deduction, which drastically reduced the revenue that states would receive. To preserve their revenue streams many states "decoupled" their death tax regimes from the federal estate tax law. A full discussion of state death tax laws is beyond the scope of this bulletin, but a deceased Canadian's estate may also be subject to a separate state death tax, depending on which states their assets are located.

Seven states impose an inheritance tax. An inheritance tax is the inverse of an estate tax. An estate tax imposes a tax on the estate of a deceased based on the value of what the deceased transferred to others. An inheritance tax imposes a tax on a person who receives assets at someone else's death. If a beneficiary lives in one of the seven states that impose an inheritance tax, the beneficiary could be subject to that tax.[7] Since the tax applies to the beneficiary, a Canadian citizen/resident's estate plans could be affected by this tax even if the Canadian citizen/resident had no U.S. situs assets at death. One beneficial aspect of the inheritance tax is that a life insurance policy death benefit isn't subject to inheritance tax in any of the seven states that impose the tax.

[7] Indiana, Iowa, Kentucky, Maryland, Nebraska, New Jersey and Pennsylvania.

Generation skipping transfer tax (GSTT)

After the United States introduced its estate and gift tax regimes wealthy American families realized that they could reduce the tax owing on transfers within their families. They did this by passing property directly to grandchildren or great grandchildren at death. The family could eliminate an opportunity for the federal government to tax their wealth by skipping a generation.

The planning strategy wouldn't be to disinherit a generation. The children not receiving the family fortune would receive enough to live well. Alternatively, the family fortune could be transferred to a trust with the children entitled to the trust income. But the grandchildren and great grandchildren would receive the bulk of the family fortune. They would be expected to conserve it, grow it if possible, and pass it on to their grandchildren and great grandchildren.

Unfortunately, Congress discovered the benefits of this strategy, too, and the IRC now imposes an additional tax on transfers of property that skip a generation, either through gifts made during life or at death.

The GSTT is imposed at a flat 40% rate, with a $5.43 million exemption (2015 limit, indexed to inflation). The tax and exemption apply in addition to any gift or estate tax to an individual who's at least two generations younger than the transferor.

The GSTT is imposed in addition to any other transfer taxes, making transfers to individuals two generations or more removed very costly. However, it's also a tax that will apply only to the very wealthy. The $5.43 million exemption is allowed separately from the unified credit, and, like the unified credit, is doubled for U.S. citizen spouses.

Summary

U.S. gift tax, estate tax and GSTT may have a major impact on Canadian citizen/residents. Without proper planning, a Canadian could face larger tax liabilities than expected. Clients should review their personal situations in light of the above discussion to assess whether they might be subject to these taxes.

Probate fees in the U.S. and state estate tax rules should also be considered as part of the analysis. Note that the Treaty doesn't reduce state inheritance taxes, though it does allow a credit against Canadian federal (not provincial) taxes for them. Having a U.S. will and powers of attorney should also be considered.

Various tax-planning strategies are available to reduce U.S. estate taxes. Life insurance can be a cost-effective way to minimize the impact of U.S. estate tax and should be considered when building a client's wealth and tax planning strategy. The key to achieving tax savings and making sure to benefit from efficient estate planning strategies is to make sure that all the pieces fit together from a financial, insurance, tax and estate planning point of view. An essential element is to make sure that the Canadian tax implications of any U.S. tax or estate tax strategy have been thoroughly analyzed. Seeking advice from a cross-border tax and estate tax expert should be the starting point for clients who want to benefit from tax efficient planning strategies.

For more information

The following publication is available for download from the Canada Revenue Agency's website: "Canadian Residents Going Down South" (P151(E) Rev. 08), at http://www.cra-arc.gc.ca/E/pub/tg/p151/p151-08e.pdf.

The IRS also publishes a guide available for download, IRS Publication 519 "U.S. Tax Guide for Aliens", (last revised April 19, 2009) at http://www.irs.gov/pub/irs-pdf/p519.pdf.

Any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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