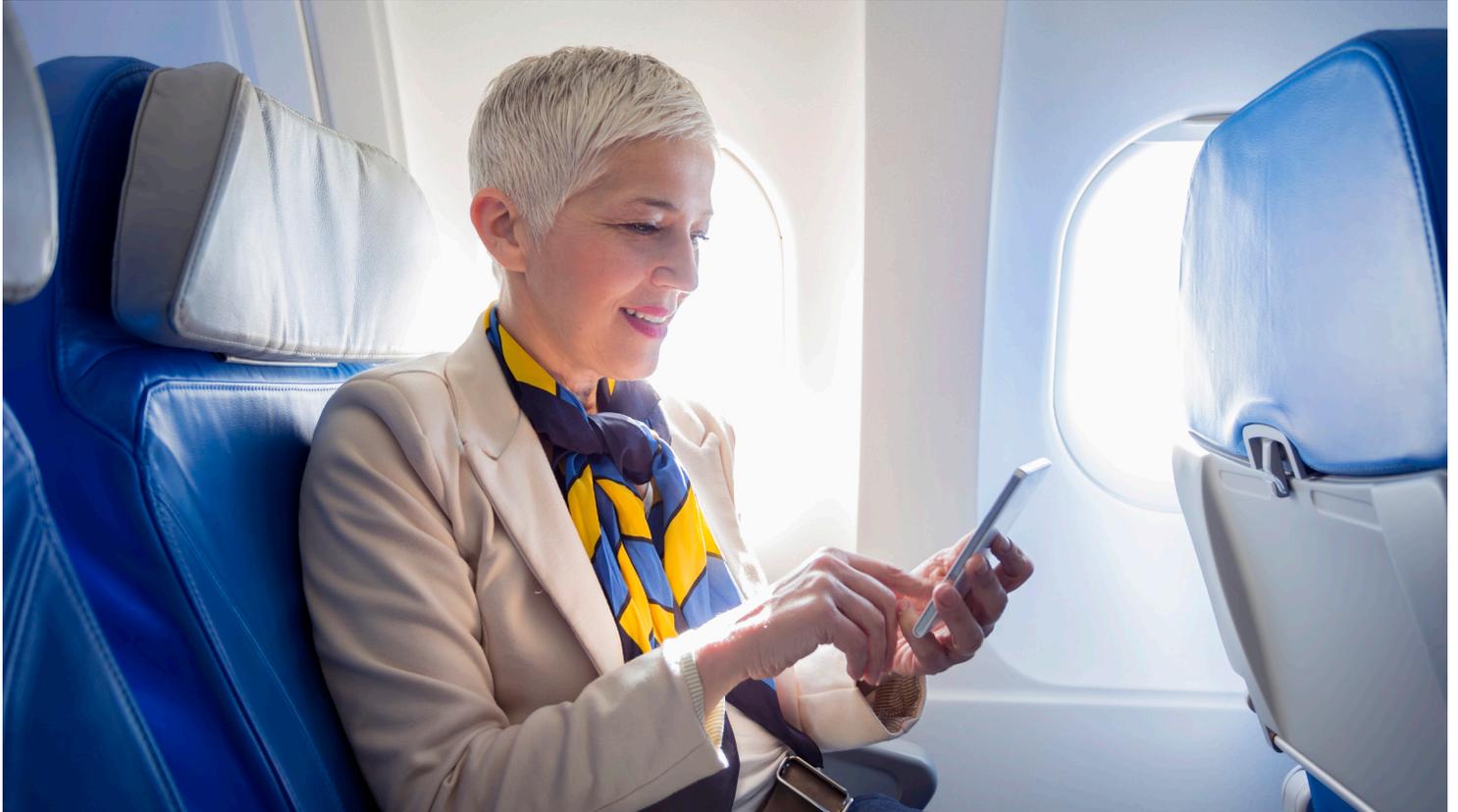


U.S. Federal Estate Tax

Strategies to help minimize liability for high net worth Canadians



There are several strategies that high net worth (HNW) Canadians can use to help minimize exposure to the U.S. estate tax.

This article is intended for Canadian residents who are not U.S. citizens or green card holders and are not domiciled in the U.S. (collectively referred to as a “U.S. person”). These strategies may not be suitable for Canadian residents who are U.S. persons.

Individuals who hold U.S. situs assets with a fair market value of more than US\$60,000 and whose worldwide assets exceed US\$11.4 million may have U.S. estate tax exposure. U.S. situs assets are generally those with a U.S. location or connection including U.S. real estate and shares in U.S. corporations. In addition to the federal tax, certain states have their own estate/inheritance tax; however, the impact of this estate/inheritance tax is beyond the scope of this article.

The first step in planning to mitigate Federal U.S. estate tax is to determine if there is a potential estate tax liability. For a broader discussion on the calculation of U.S. estate tax, please see the TD Wealth article titled “U.S. Federal Estate Tax Implications for High Net Worth Canadians: Determining if You Have Any Liability”.



Where it is determined that the potential for a material U.S. estate tax liability exists, there are a range of strategies that HNW Canadians can use to effectively reduce or eliminate this exposure. Tax Reform legislation enacted at the end of 2017 temporarily doubled the lifetime exemption amount for U.S. Federal Estate Tax (“U.S. estate tax”). If new legislation is not enacted by the end of 2025, the lifetime exemption amount will revert to the amount under prior law of US\$5 million adjusted for inflation to 2026. While planning strategies are important to minimizing U.S. estate tax exposure, the frequent changes to the U.S. estate tax regime will require that planning be revisited regularly to ensure it is still appropriate for enacted legislation.

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The following are a few of the common strategies to consider and discuss with a qualified cross-border tax advisor before implementation:

1. Alternative investment strategies

Rather than investing in the U.S. directly, HNW Canadians may wish to consider investments with underlying exposure to the U.S. that are not treated as U.S. situs assets. These may include:

- Shares of Canadian mutual fund corporations that invest in the U.S.;
- Units of Canadian mutual fund trusts that invest in the U.S.;
- Units of Canadian-listed exchange-traded funds (ETFs);
- American Depository Receipts (ADRs);
- U.S. government and corporate bonds subject to the portfolio interest exemption; and
- Canadian issuer bonds denominated in U.S. dollars.

2. Gift U.S. securities during your lifetime

The advantage of gifting U.S. securities (or other intangible U.S. situs assets) during your lifetime is that you are able to reduce the value of such U.S. situs assets at death and therefore minimize U.S. estate tax. The downside of this method is that you may have to pay Canadian tax in the year the gift is made. If you make a gift, you are deemed by Canadian tax rules to dispose of that asset at its fair market value, thus triggering capital gain if the asset has increased in value. There is an exception if the gift is to your spouse; but, be wary, as the spousal attribution rules may apply on the investment income generated on the properties gifted to your spouse.

Gifting U.S. real estate or tangible personal property (e.g., cars, boats, jewelry) located in the U.S. is generally not an effective planning option as such gifts can trigger U.S. gift tax if the gift exceeds a certain amount (US\$155,000 for a non-U.S. citizen spouse and US\$15,000 for all other donees, for 2019). U.S. gift tax is levied at the same rates as the U.S. estate tax.

3. Sell U.S. situs assets prior to death

Selling U.S. situs assets prior to death will result in a reduction in the value of your U.S. situs assets at death. The advantage of this strategy is that it is simple to execute, but it may only be practical if death is imminent. Otherwise you may be triggering a premature tax liability arising from the sale.

4. Leave U.S. situs assets to your spouse

When you leave U.S. situs assets to a surviving spouse, in addition to a unified credit (up to US\$4,505,800¹ for 2019) available under the Canada-U.S. Tax Convention (the “Treaty”), your estate may benefit from a marital credit to help minimize or eliminate U.S. estate tax. For 2019, a married couple with U.S. situs assets could have worldwide assets of up to US\$22.8 million without being subject to U.S. estate tax on the death of the first spouse.

To benefit from the marital credit, a number of conditions must be satisfied, including:

- The property must pass to the surviving spouse in a way that would qualify for the estate tax marital deduction under U.S. domestic law if the surviving spouse had been a U.S. citizen and all applicable elections had been properly made.
- At the time of death, the deceased was either a resident of Canada or the U.S., or a citizen of the U.S.;
- At the time of death of the deceased spouse, the surviving spouse was a resident of either Canada or the U.S.;
- If both the deceased and the surviving spouse were residents of the U.S. at the time of death, one or both was a citizen of Canada; and
- The executor of the deceased's estate elects to use the marital credit and irrevocably waives the use of any estate tax marital deduction that would be allowed under the U.S. tax law. This means that a qualified domestic trust (QDOT) (described in more detail below) would not be available if an election was made to use the marital credit.

Where the conditions above are satisfied, the marital credit available is the lesser of:

- The amount of the unified credit available to the decedent's estate; and
- The amount of estate tax attributable to the qualified property.

When all available credits, including the marital credit, cannot eliminate the potential U.S. estate tax liability, you may consider leaving assets in a QDOT to help defer the U.S. estate tax. A QDOT is an irrevocable trust for the sole benefit of a non-U.S. citizen-surviving spouse, and is a tool that allows property to pass to a non-U.S. citizen-spouse and still qualify for the unlimited marital deduction afforded to U.S. citizen spouses.

There are a number of requirements in order for a trust to qualify as a QDOT. For example, at least one trustee of the trust must be a U.S. citizen or a U.S. corporation. If the trust

holds more than US\$2 million in assets, the trustee must be a U.S. bank or trust company, or a bond or letter of credit must be provided in favour of the Internal Revenue Service (IRS). In addition, no distribution (other than a distribution of income) may be made from the trust without the U.S. trustee having the right to withhold U.S. estate tax.

If the QDOT is structured properly to conform to Canadian tax laws as a qualifying spousal trust, the Canadian capital gains tax triggered on death may also be deferred to the death of the surviving spouse or a subsequent disposition of the assets by the surviving spouse.

5. Use a non-recourse mortgage

A non-recourse mortgage is a mortgage that entitles the lender to have recourse only against the property mortgaged.

Having an outstanding non-recourse mortgage on your U.S. real estate will reduce your equity in the property dollar for dollar and hence, the value of the property subject to U.S. estate tax. Non-recourse debt, however, is difficult to obtain.

6. Use a Canadian holding company to hold U.S. situs assets

Holding U.S. situs assets in a Canadian corporation would allow you to exchange your U.S. situs assets (e.g., shares of U.S. corporations) for non-U.S. situs assets (i.e., shares and/or debt of a Canadian corporation).

The rationale behind using a Canadian holding company to hold U.S. situs assets is that you no longer own U.S. situs assets directly. Rather, you own shares of a Canadian corporation, which is not considered a U.S. asset.

Disadvantages of this alternative include:

- Initial set-up costs, as well as ongoing legal, accounting and tax compliance fees.
- The IRS may challenge corporations set up for such purposes on the basis that they are sham corporations, which may result in the IRS looking through the corporate shell to the ultimate owner and assessing U.S. estate tax on the death of the ultimate owner.

- You may end up paying more Canadian taxes on the income earned from these U.S. situs assets when you earn it through a corporation rather than personally.
- If you use a Canadian corporation to hold personal-use real estate property (such as a vacation home) located in the U.S., you may be taxed in Canada for receiving a shareholder benefit from your corporation.

Historically, many Canadians with personal-use real estate in the U.S. used a “single-purpose corporation” to purchase or to hold the real property seeking to minimize the U.S. estate tax on death. While grandfathering of certain arrangements that were already in place may apply, commencing in January 2005, it is no longer advisable to acquire personal-use real property in a corporation, as the Canada Revenue Agency views the use of such corporate assets as giving rise to a taxable shareholder benefit.

7. Using a Canadian trust to hold U.S. situs assets

If properly established, a Canadian discretionary trust may shelter U.S. situs assets held by the trust from U.S. estate tax. If the property is subsequently sold by the trust, capital gains not allocated to trust beneficiaries would be taxed in the hands of the trust.

While a discretionary trust is relatively easy to set up and maintain, it requires that the owner give up asset ownership as well as control of that asset (if the owner is not the sole trustee or one of the trustees). In addition, the transfer of the asset into the trust may result in a taxable disposition for the owner for Canadian tax purposes.

8. Using a Canadian partnership to hold U.S. situs assets

Other structures such as the use of a Canadian partnership or a hybrid Canadian partnership (which is treated as a corporation for U.S. tax purposes) may help reduce exposure to U.S. estate tax. These structures are often used to hold real estate assets, however they have high set-up and annual compliance costs due to their complexity.

9. Charitable donations upon death

Canadians with a desire to donate to a U.S. charity may wish to consider donating U.S. situs assets to a U.S. charity through their Wills. The value of the donation would be deducted from the value of the property in calculating U.S. estate tax. In addition, if the donated property has accrued gains, the Treaty provides an option for the donor to elect, for Canadian tax purposes, to have proceeds of disposition equal to the cost of the donated asset so that no capital gains result from the disposition. However, be aware that under certain circumstances the amount of the donation to a U.S. charity eligible for charitable donation tax credit in Canada may be limited by the amount of U.S. source income reported in the Canadian tax return.

10. Structuring ownership in joint tenancy

Canadians may hold a U.S. property in joint tenancy with right of survivorship where the property passes automatically to the surviving joint owner on the death of the first owner. This form of ownership minimizes probate fees on death because the property passes outside of the estate. However for individuals who are not U.S. persons, the full value of a U.S. situs asset is included in the estate of the first to die unless the executor can prove that the surviving joint owner contributed funds to the purchase of the property. If the U.S. property is held as tenants in common, each owner would be subject to estate tax only on their proportionate interest as well as providing an opportunity to undertake planning for the U.S. property at death. Since the U.S. property will pass through the estate, there may be probate costs that should be considered.

11. Use life insurance to fund payment of estate tax

The sale of your U.S. situs assets may not be necessary if sufficient life insurance is in place to fund the potential U.S. estate tax liability and other costs that may arise upon your death. Life insurance proceeds payable to your estate will generally not form part of your U.S. assets on death, even if a U.S. insurer issues the policy. However, if at death you

have any “incidents of ownership” (e.g., being an owner or a beneficiary in a policy), these insurance proceeds will form part of your worldwide assets for the purposes of determining U.S. estate tax thresholds and calculations, and will result in a lower unified credit under the Treaty. To avoid an increased estate tax liability, it may be beneficial under certain circumstances to hold a life insurance policy in an irrevocable life insurance trust (ILIT). However, depending on your age and health, it may not always be possible to acquire insurance coverage, or the cost may be too high.

Consider

If you may have an exposure to U.S. estate tax, speak with your TD advisor and a cross-border tax advisor about what strategies may be appropriate in minimizing your U.S. estate tax exposure.



¹The unified credit of US\$4,505,800 (for 2019) is the equivalent of the U.S. estate tax on assets of US\$11.4 million.

This article provides a general overview of some of the U.S. and Canadian tax considerations for Canadian residents around certain types of U.S. retirement accounts. It does not address additional considerations applicable to persons who are U.S. citizens, green card holders or individuals who are otherwise treated as residents of the United States for U.S. tax purposes. The U.S. and Canadian tax rules are complex, and tax consequences can vary depending on your individual circumstances. Be sure to speak with your tax specialist before taking any action with respect to any retirement accounts.

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