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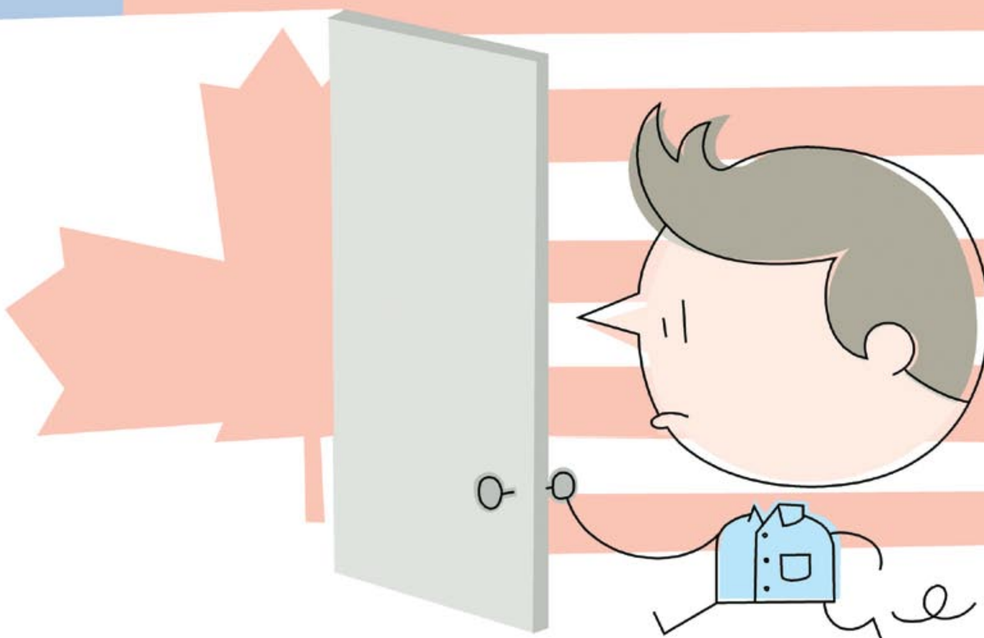
Ties to U.S. and Canada



Differences in taxation of transfers affect bequests and gifts.

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THE DISTINCTIVE challenges associated with the taxation of bequests and lifetime gifts made by individuals with ties to both the United States and Canada arise from the fact that the United States has federal estate and gift taxes, while Canada has neither form of transfer tax. Instead, Canada imposes a federal income tax on 50 percent of the appreciation on property owned at death or given away during lifetime.

While the 1995 (Third) Protocol (the Protocol) to the 1980 Canada-U.S. Income Tax Treaty (the Treaty) smooths out many of the wrinkles created by these two different regimes of gift and inheritance taxation, taxpayers can still benefit from planning in order to minimize tax.

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U.S. Overview

The United States imposes federal estate and gift taxes on the "gratuitous" transfer of property "wherever located" by U.S. citizens or domiciliaries ("U.S. persons"). The current estate and gift tax rates range from 18 percent to 45 percent, depending on the value of the property transferred. Many states also have state estate taxes and a few have state gift taxes.

U.S. persons are currently allowed a credit, sometimes called the unified credit, enabling them to pass up to $2 million free of estate tax, $1 million of which can be transferred by gift during lifetime. Absent treaty relief, estates of persons who are not U.S. citizens or domiciliaries ("non-U.S. persons") are entitled to a miniscule credit

allowing them to transfer only $60,000 worth of U.S. property free of estate tax. There is no similar credit for non-U.S. persons as to U.S. gift taxes.

An unlimited gift and estate tax marital deduction is available, which allows transfers of property to a U.S. citizen spouse without incurring either tax. Although the marital deduction is not available for the transfer of property to a non-U.S. citizen spouse, gifts of up to $125,000 a year (indexed for inflation) can be made to a non-U.S. citizen spouse without incurring gift tax. An individual can also transfer property at death to a qualified domestic trust or QDOT for the benefit of a non-U.S. citizen surviving spouse without incurring an estate tax unless and until principal distributions are made to the spouse or the spouse dies.

The following assets are subject to U.S. estate tax if owned by non-U.S. persons at death: (1) real property located in the United States; (2) tangible property located in the United States; (3) shares of stock in U.S. corporations, including residential co-ops; (4) mutual funds organized in the United States; (5) cash deposits with U.S. brokers (but not with U.S. banks), including money market accounts with U.S. mutual funds and cash in U.S. safety deposit boxes; (6) debts of U.S. obligors other than certain bonds issued after July 18, 1984; and (7) cash value of life insurance policies on the life of a person other than the non-U.S. decedent issued by U.S. life insurance companies. (There is considerable uncertainty as to whether interests in partnerships and limited liability companies holding the assets described above are U.S. property.)

For U.S. gift tax purposes only real property and tangible property located in the United States are subject to gift tax if transferred by a non-U.S. person. Significantly, interests in non-U.S. corporations and other foreign entities that are treated as corporations for U.S. tax purposes are not considered U.S. property, either for estate or gift tax purposes.[1]

Canadian Overview

In 1971 Canada replaced its federal estate and gift tax system with a tax on capital gains linked to the Canadian income tax. Soon thereafter the provinces and territories followed suit. Events such as death or making a gift are "deemed dispositions" of property by Canadian residents and therefore subject to gains tax. Fifty percent of all of capital gains (net of capital losses) are included in the income of Canadian residents. Canadian income tax rates for individuals currently range from 15.5 percent to 29 percent. Tax on such gains may be deferred if a disposition is made to a Canadian resident spouse (including common law and same-sex spouses).

Canada generally imposes income tax on individuals who are "residents" of Canada. An individual will be deemed to be a Canadian resident if he or she is physically present in Canada for 183 days or more in a calendar year or if he or she is "ordinarily resident" in Canada, which could occur if a person has a habitual abode in Canada but is present for less than 183 days a year. Various other factors may be examined to determine an individual's residence for Canadian tax purposes.

The 1995 (Third) Protocol to the 1980 Canada-U.S. Income Tax Treaty smooths out many of the wrinkles created by these two different regimes of gift and inheritance taxation.

U.S. persons who are not Canadian residents are subject to Canadian income tax on sales and deemed dispositions of certain types of taxable Canadian property, such as real property located in Canada, interests in Canadian companies, partnerships, trusts or estates that derive their principal value from Canadian real property, and personal property forming part of the business property of a permanent establishment resident in Canada ("Taxable Canadian Property").

Taxation Upon Death

Part 1: U.S. Persons Who Die Owning Canadian Property. While the U.S. estate tax provides a credit against foreign death taxes paid, this credit is limited to death and inheritance taxes and does not include income taxes. Helpfully, the Treaty provides relief from potential double taxation by providing estate tax credits for Canadian gains taxes on death-related property dispositions. The Protocol provides that income tax paid to Canada on the deemed disposition of Taxable Canadian Property upon the death of a U.S. person, whether or not a Canadian resident, is treated as a foreign death tax and, therefore, the United States must give a credit against the U.S. estate taxes imposed on the Canadian property for income tax paid to Canada.

Canadian tax law also provides for a deferral of tax on property that is transferred to a Canadian surviving spouse or a spousal trust at death. In effect, if an individual bequeaths real property to a surviving spouse who is a resident of Canada, that property is treated as being disposed of at its cost basis, with no recognition of gain or loss at the time of the transfer. As a result, the recognition of gain or loss will be deferred until the earlier of the sale or deemed disposition of the property by the surviving spouse. When an individual owning Canadian property is a resident of the United States immediately before death, the Treaty (as amended by the Protocol) extends this deferral benefit by treating the U.S. resident surviving spouse as a resident of Canada.

Part 2: U.S. Citizens Who Die as Canadian Residents. When a U.S. citizen dies resident in Canada owning U.S. property, Canada is obligated under the Treaty to give a tax credit against the Canadian federal income tax imposed on the deemed disposition of the U.S. property for U.S. estate taxes. However, the amount of this credit is limited to the estate taxes that would have been payable to the United States if the individual were not a U.S. citizen. The concept appears to be that, between this Canadian credit for U.S. estate taxes on the U.S. property and the U.S. credit for Canadian tax on the Canadian property discussed in Part 1, double taxation should effectively be avoided. However, most provinces take the position that the Treaty does not apply to them and the credit may not offset their portion of the tax (which can be as high as one-half of the income tax assessment).

Part 3: Canadian Residents Who Are Not U.S. Citizens and Die Owning U.S. Property. The Treaty (as amended by the Protocol) provides significant benefits to non-U.S. citizen Canadian residents who die owning U.S. property. The Treaty

provides that Canadian residents are entitled to a unified credit against U.S. federal estate tax equal to the greater of (i) the unified credit available to estates of non-U.S. persons, which is currently $60,000, and (ii) a pro-rated portion of the unified credit available to estates of U.S. persons based on the value that an individual's gross U.S. estate bears to the value of such individual's worldwide estate. This means that a Canadian resident will not be subject to federal estate tax if the value of his worldwide assets is less than the amount of the unified credit, which is currently $2 million.

The Treaty also provides that, instead of using a QDOT to obtain a marital deduction, the estate of a Canadian decedent can take advantage of a marital credit that is available for U.S. property transferred to a surviving non-U.S. citizen spouse who is either a Canadian or U.S. resident (or to a spousal trust for such person). The amount of this additional credit is limited to the smaller of (i) the amount of the unified credit discussed in the previous paragraph allowable to non-U.S. citizen Canadian residents who die owning U.S. property, and (ii) the amount of additional estate tax that would otherwise be imposed on the property left to the spouse, if such property were subject to U.S. estate tax.

When U.S. federal estate tax is imposed on the estate of a Canadian decedent owning U.S. property, the Treaty provides a credit against any Canadian federal income tax for the U.S. estate tax paid on the U.S. property equal to the smaller of the two taxes. This credit will be useful in situations where the value of the U.S. property is significantly greater than its cost basis immediately prior to the death of the Canadian resident. For most Canadian residents in such a situation, however, there may still be some double taxation because the U.S. estate tax may not offset the provincial component of the Canadian gains tax.

Historically, many Canadian residents who owned U.S. property planned to avoid U.S. estate tax by holding the U.S. property through a Canadian holding company. Canadian law, however, imposes a substantial disincentive to such a strategy by imputing income to the shareholder for the use of property owned by the corporation. An exemption from this treatment for so-called "single-purpose corporations" was abolished in 2005 on the theory that the Protocol eliminated the danger that U.S. property owned by Canadian residents would be subject to double death taxes. However, this Canadian Revenue ruling ignored the fact that, even with the benefit under the Protocol of the credit for U.S. estate tax against the Canadian capital gains tax, the estate of a Canadian resident might be paying a net additional U.S. tax of as much as 30 percent of the value of the U.S. property for the privilege of owning property in the United States instead of in Canada. Canada does not have limited liability companies, which are generally untested as barriers to U.S. estate tax on property owned by non-U.S. persons anyway. Alternative strategies that might be considered include the use of non-recourse debt, life insurance and possibly acquiring U.S. property through partnerships.

Part 4: Canadian Citizens Who Die Resident in the United States. A Canadian citizen will be subject to worldwide U.S. estate tax if he is treated as a domiciliary of the United States at the time of his death. Since Canada taxes income based on residence, such a Canadian citizen will be exempt from worldwide Canadian income tax on the deemed disposition of assets at death because this tax applies on a worldwide basis only to residents of Canada. However, this individual will still be subject to Canadian income tax on the disposition of any Taxable Canadian Property, subject to the credits and deductions of the Treaty.

Taxation of Gifts

The United States has no statutory credit for foreign gift taxes. Therefore, while gifts of real property and tangible property located in the United States made by Canadian residents who are non-U.S. persons are subject to both Canadian income tax and U.S. gift tax, there is no offsetting U.S. tax credit. Similarly, a gift of Taxable Canadian Property by a U.S. person will be subject to both U.S. gift tax and Canadian income tax on the deemed disposition without any relief from double taxation. To make matters worse, the donee will have a "carry over" tax basis in the gifted property for U.S. income tax purposes, although a Treaty election may be available to treat this disposition as a simultaneous taxable event for U.S. purposes.

One solution to this problem for Canadian residents is to structure gifts so that they are not gifts of U.S. property. For example, if real property located in the United States is owned by a Canadian holding company, subject to the concerns discussed above in Part 3, the gift of the shares would not be subject to U.S. gift tax. With respect to a U.S. person, if a gift must be made of Taxable Canadian Property, it would be more efficient to make a gift of property with little or no appreciation to minimize the Canadian income tax liability with respect to the deemed disposition.

Charitable Contributions

Absent treaty relief, no U.S. income tax deductions are available for contributions made by U.S. persons to foreign charities. A similar limitation is imposed under the Canadian income tax law. In addition, in many cases, U.S. gift or estate tax deductions are not available for gifts or bequests made by U.S. persons to foreign charities unless the foreign charity is organized and operated exclusively for religious, charitable, scientific, literary or educational purposes and would not be disqualified for tax exemption under U.S. tax law.[2]

Subject to certain limitations, the Treaty allows U.S. persons to receive U.S. income and estate tax deductions for contributions and bequests made to Canadian charities and allows Canadian residents to receive income tax credits for contributions and bequests made to U.S. charities. The Treaty also permits a full U.S. estate tax deduction for U.S. property that is specifically devised to Canadian public charities.

1. For more details on planning, see Michael W. Galligan, "Buying USA: Ways of Minimizing U.S. Transfer Taxes on U.S. Property Interests of Non-U.S. Persons," STEP USA, June 2007.
2. For more details, see Michael W. Galligan, "International Charitable Giving and Planning Under U.S. Tax Law," Tax Management Estates, Gifts and Trusts Journal, Vol. 29, No. 03, May 13, 2004.

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