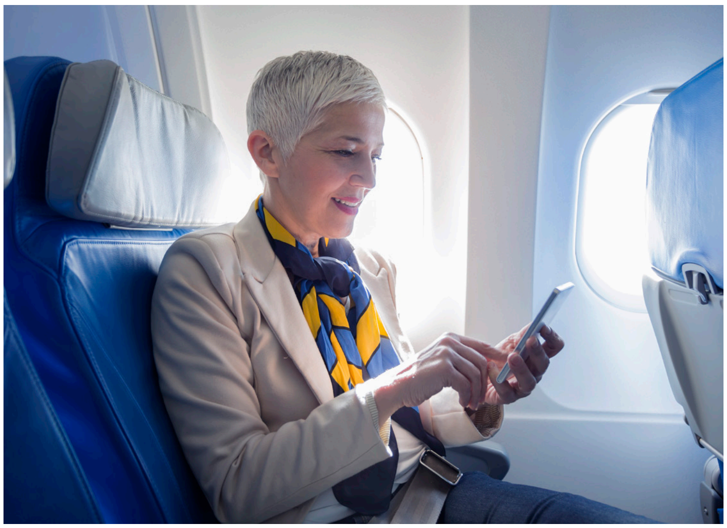
U.S. Federal Estate Tax: Strategies to Help Minimize Liability for High Net Worth Canadians



The *Tax Cuts and Jobs Act (TCJA)*, signed into law in December 2017, doubled the lifetime exclusion amount for U.S. Federal Estate Tax ("U.S. estate tax") as of 2018[1]. 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. These strategies may not be suitable for Canadian residents who are U.S. citizens or green card holders.

Individuals who hold U.S. situs assets[2] with a fair market value of more than US$60,000 and whose worldwide assets exceed US$11.18 million may have U.S. estate tax exposure. Under the U.S. estate tax rules, U.S. situs assets are generally those with a U.S. location or connection including U.S. real estate, shares in U.S. corporations, etc. Certain states have an estate/inheritance tax; however, the impact of state estate/inheritance tax is beyond the scope of this article.

The first step in planning to mitigate U.S. estate tax is to determine whether or not there is potential for a significant tax liability. For 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 ascertained that the potential for a material U.S. estate tax liability exists, there is a range of strategies that HNW Canadians can use to effectively reduce or eliminate their exposure.

[1]The increased lifetime exclusion amount of US$11.18 million for 2018 is subject to a sunset clause at the end of 2025. If new legislation is not enacted, the lifetime exclusion amount will revert to the pre-2018 exclusion amount, subject to inflation adjustment for 2026.
[2]U.S. situs assets under U.S. estate tax rules refers to property situated within the U.S. and generally includes, but is not limited to, U.S. real estate, shares of U.S. corporations, U.S. listed exchange-traded funds, tangible personal property located in the U.S., U.S. retirement plans, debt obligations of U.S. persons, and deposits with a U.S. brokerage.

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

1. Alternative Investment Strategies

Rather than investing in the U.S. directly, HNW Canadians may wish to review investments with underlying exposure to the U.S. that are not considered to be 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 taxes 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 gains 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 those gifts can trigger U.S. gift taxes if the gift exceeds certain amounts (US$152,000 for a non-U.S. citizen spouse and US$15,000 for all other donees, for 2018). 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$4,417,800[3] for 2018) 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 2018, a married couple with U.S. situs assets could have worldwide assets of up to US$22.36 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. Specifically:

- 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.

[3] The unified credit of US$4,417,800 (for 2018) is the equivalent of the U.S. estate tax on assets of US$11.18 million.

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. The lender cannot bring suit against the mortgagor for any balance owing if the property is not worth enough to pay off the debt.

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. The downside of this alternative is that a non-recourse mortgage may be difficult to obtain.

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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 Internal Revenue Service (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

A Canadian discretionary trust, if properly set up, may shelter U.S. situs assets held by the trust from U.S. estate tax on the original owner. 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. A potential drawback to consider is 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. 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 on 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.

28/05/2018