# Canadians may be subject to U.S. estate tax on death

As a Canadian resident,[1] you may end up leaving a piece of your estate to the U.S. tax authorities when you pass away. That's right. Even if you've never lived or worked in the United States, and have no citizenship ties to the country. This article explores how U.S. estate tax can affect Canadians, and a few strategies for dealing with it.

## U.S. estate tax on U.S. situs assets

The U.S. levies an estate tax on death, calculated on the total *value* of the deceased's wealth.[2] American citizens and residents are subject to this tax on their entire wealth, wherever situated. Canadians and other foreigners are subject to this tax if their wealth includes "U.S. situs assets".

U.S. situs assets generally *include*:

- Real estate situated in the United States,
- U.S. pension plans (e.g. IRAs and 401k plans),
- Shares in U.S. corporations, and
- Certain debts issued by U.S. persons (e.g. between members of a family).

Any of the above assets held through a registered plan (e.g. RRSP or RRIF) or through a typical Canadian discretionary trust, is also included.

The following assets are typically *excluded*:

- Mutual funds traded outside the U.S. (even if the fund itself owns shares in U.S. corporations),
- U.S. denominated bank deposits (whether with a Canadian or U.S. bank),
- U.S. corporate bonds,
- U.S. government debt including T-bills,
- Life insurance death benefits, and
- U.S. situs assets held through a Canadian corporation.[3]

The excludability of U.S. assets held through partnerships and hybrid entities, such as unlimited liability companies, is controversial. If you have an interest in any of these entities, expert advice is recommended.

## Estate tax computation and treaty exemption

Estate tax applies at graduated rates ranging from 18% to 40%. You move up through the rates quickly. U.S. assets in excess of US $100,000 are subject to a 30% rate. The 40% rate applies to asset values of US$1 million or more.

Canadians are entitled to relief under the Canada-U.S. Treaty. **As a rule-of-thumb, if you die in 2023 owning US $12.92 million[4] or less on a worldwide basis, your estate will not owe U.S. estate tax.**

If your worldwide estate is in excess of the exemption, your estate will be subject to tax on the value of your U.S. situs assets. With the Treaty, you can reduce the tax by a credit of US $5,113,800[5] multiplied by the ratio of your U.S. assets to your worldwide assets.

The compilation of an estate for U.S. estate tax purposes differs from how you compile an estate for Canadian tax purposes. For instance, assets held in a typical Canadian discretionary family trust are generally included in your estate for U.S. estate tax purposes. Life insurance proceeds are also typically included. That's the case even if they're payable to your named beneficiaries and are otherwise excluded from your probate estate.

Let's take an example to illustrate how the U.S. estate tax system works. Assume you are an entrepreneur with a common-law partner and two adult children. You pass away in 2023 owning the following assets.[6]

| **Assets**<br>All CA $ unless specified | **Gross Asset Value** | **Estate Inventory For Canadian purposes** | **U.S. Situs Assets For U.S. purposes** | **Worldwide Estate For U.S. purposes** |
|---|---|---|---|---|
| Canadian liquid assets & investments | $260,000 | $260,000 | N/A | $260,000 |
| U.S. bank account | $40,000 | $40,000 | N/A | $40,000 |
| RRSP | $1,000,000 ($400K in U.S. stocks) | $1,000,000 | $400,000 | $1,000,000 |
| Principal residence<br>50% interest | $900,000 | $450,000 | N/A | $900,000<br>*Takeaway 1* |
| Florida condo<br>33% interest | $750,000 | $250,000 | $750,000<br>*Takeaway 1* | $750,000<br>*Takeaway 1* |
| Preferred shares in PRIV Canada Inc. | $5,000,000 | $5,000,000 | N/A | $5,000,000 |
| Common shares in PRIV Canada Inc., held by a discretionary family trust | $13,000,000 | N/A | N/A | $13,000,000<br>*Takeaway 2* |
| Life insurance proceeds<br>Beneficiary: ex-spouse | $2,000,000 | N/A | N/A | $2,000,000<br>*Takeaway 2* |
| **TOTAL** | | **$7,000,000** | **$1,150,000** | **$22,950,000** |
| **Total in US $**<br>FX @ US $1 = $1.30 (rounded) | | | **US $885,000** | **US $17,654,000** |

In this illustration, the U.S. estate tax liability payable by your estate is US $44,494, computed as follows:

- Gross tax on US $885,000 of U.S. situs assets, using the graduated rates table = US $300,950.
- Treaty credit equals US $5,113,800 * 885,000 / 17,654,000 = US $256,456.
- Gross tax (US $300,950) minus Treaty credit (US $256,456) = US $44,494.

Takeaways from this illustration include:

1. The value of jointly-owned property must generally be included in full for U.S. estate tax purposes. This rule applies to U.S. situs and foreign assets alike. You can limit the inclusion to your fair share if you own the property as tenants in common,[7] or if you can demonstrate that the co-owners contributed their own funds to the original purchase price. In practice, tracing the source of funds is difficult to substantiate, particularly between members of a family.

2. As indicated above, certain assets may be excludible from your Canadian probate estate but they still form part of your worldwide estate for U.S. estate tax purposes. Had the discretionary trust held U.S. situs assets in this example, these would increase the tax *and* decrease the Treaty credit. When assessing your exposure to U.S. estate tax, beware of assets that you consider, based on your knowledge of Canadian rules, not to be "yours".

3. Married taxpayers are eligible for an enhanced Treaty credit when they bequeath their U.S. assets to their surviving spouse. The credit equals the lesser of the estate tax you would otherwise have owed (US $44,494 in this case) and the prorated unified credit (US $256,456 in this case). Had you been married[8] and left your estate to your spouse in this illustration, your estate's U.S. estate tax liability would have been nil. This additional relief is appealing. However, it boils down to a mere deferral of tax where the surviving spouse passes away in a later year holding the same assets, plus their own.

4. Given the high exemption room, you may be tempted to conclude that it is not worth planning for U.S. estate tax. Beware. The exemption will automatically decrease to US $5 million (indexed for inflation) as of January 1, 2026.

## Capital gains tax

For Canadian income tax purposes, you are deemed to dispose of your worldwide assets immediately prior to your death. As such, any accrued gain on your U.S. situs assets is subject to Canadian capital gains tax on your death. If your estate is subject to U.S. estate tax on those same assets, will one tax offset the other? The answer is yes, with limitations. Under the Treaty, Canada will grant your estate relief in the form of a credit for the U.S. estate tax paid against the Canadian tax specifically attributable to your U.S. situs assets. The Treaty relief typically applies to federal tax only. Provincial tax is not creditable unless the province specifically allows it.

What about capital gains tax in the U.S.? U.S. estate tax applies on the *value* of U.S. situs assets. What happens to the accrued gain for U.S. tax purposes? Will your estate or your heirs be required to pay U.S. tax on this gain? Current rules provide that the accrued gain up until your death is forgiven for U.S. tax purposes.[9] Your heirs should thus be liable for U.S. tax only on the appreciation in value *after* you die.[10] If you own U.S. situs property with a significant accrued gain, consider holding on to the property until you pass away. This may overall provide for a lesser amount of U.S. taxes payable than if you sell it. You should weigh probate and other ancillary costs into this analysis.

## State tax

The United States Estate Tax is a federal law, but certain states have adopted estate taxes of their own. Currently, twelve states[11] and the District of Columbia levy an estate tax. Exemption thresholds and rates vary from state to state. As a non-resident of the state, you may be subject to state estate tax if you own property located in the state at the time of your death.

Some states[12] levy an inheritance tax. It generally applies to a deceased resident in the State. It can also apply to a nonresident with real or tangible personal property located in the State. Although paid by the estate, the tax is calculated with reference to the value of the inheritance received by certain beneficiaries. If you have property located in one of those states, you may wish to consult a U.S. tax advisor to understand the potential tax. The good news is life insurance policy death benefits generally are not subject to inheritance tax in any of the states that impose an inheritance tax. Each State has their own rates with various exemptions which we recommend you review with a US. Tax advisor.

## Estate tax filing obligations

For Canadians, the obligation to file a U.S. estate tax return is not dictated by the tax liability. If the value of your U.S. situs assets exceeds US $60,000, your executors will be required to file a U.S. estate tax return within 9 months of your death. Financial institutions and probate courts often request a transfer certificate[13] before they release the U.S. assets to the heirs, or effect title change. When the heirs dispose of the U.S. assets they inherit from the deceased, the IRS may also request a copy of the U.S. estate tax return to substantiate their cost basis in the inherited property. You should direct your executors to abide by these formalities, if applicable.

## Strategies for managing or mitigating U.S. estate tax

Various strategies are available to reduce U.S. estate tax, or to facilitate funding and payment. Consider the following:[14]

A. **U.S. estate tax can be funded using life insurance**. Life insurance is particularly useful where you anticipate a shortage of liquidities on death, or where your liquid assets are inside a corporation. The insurance proceeds will prevent a forced sale of assets and the payment of additional taxes to the Canadian government. They'll also help the administration of your estate. Consider the impact that the insurance proceeds will have on the Treaty credit calculation however, as illustrated above. The greater your worldwide assets (including insurance), the lesser the credit. To prevent the insurance proceeds from being included in your worldwide assets, a combination of insurance coverage and the use of a trust may be considered. The most common of these structures is the Irrevocable Life Insurance Trust (ILIT). It involves the creation of a Canadian trust that subscribes for an insurance policy on your life. You'll finance the premiums through trust contributions. But you'll have no right to any trust or policy benefits once the structure is in place. That means no change in beneficiaries and no borrowing against, withdrawing from or pledging the policy for a loan, amongst others. You should weigh the costs and benefits of a trust structure carefully.

B. **Placing U.S. assets in a properly structured Canadian trust may shelter these assets from U.S. estate tax on your death**. Typical discretionary family trusts will not assist in this strategy. To be an effective structure, you need to place specific restrictions on the trust limiting your personal enjoyment of, and control over, the trust property. Depending on your personal circumstances, these restrictions may not work for you. If they do, this structure will effectively minimize, perhaps eliminate your exposure to U.S. estate tax. Be sure to evaluate implementation and maintenance costs.

C. **Holding U.S. assets in a Canadian corporation may also shelter assets from U.S. estate tax on your death.** This structure is usually not viable for personal-use U.S. real estate (like vacation property) because you'll be assessed a taxable benefit for Canadian tax purposes on your use of the property. But it is effective for income-producing property such as U.S. marketable securities. This strategy is usually best suited to holding companies.[15] As a drawback, note that foreign investment income is subject to Canadian corporate tax at a higher rate than when it is earned personally. You should weigh this additional cost against the U.S. estate tax saving.

D. **Sophisticated structures involving stacked hybrid entities have gained in popularity over the years.** These structures provide for U.S. estate tax mitigation coupled with a bump in the cost basis of multi-tier entity assets. These structures are costly to design and implement, so they usually cater only to the ultra high net worth.

To conclude, taxes on death carry multiple considerations, some Canadian and some foreign. If you own U.S. assets or if one of your heirs is a citizen or resident of the United States, unwelcome U.S. tax consequences may arise when you pass away. Please consult your tax advisor to examine the issues that apply to your particular situation. If you don't, the U.S. tax authorities may get a bite into your estate before your heirs receive their share of what you spent your whole life earning and leaving aside for them.

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Published and revised by: Estate & Financial Planning Services
Last revised: January 2023


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[1] If you or your spouse are American citizens or residents of the United States, the principles outlined in this article may not apply to you. Please consult with your tax advisor.

[2] This is to be distinguished from Canada where there is no estate tax but rather a deemed disposition tax, where the appreciation in value of the deceased's assets is subject to Canadian capital gains tax and certain other assets are included in income.

[3] As discussed further below, this strategy may not viable in certain circumstances including vacation homes, due to the Canadian tax implications associated therewith.

[4] This exemption amount applies to deaths occurring in 2023. It is indexed annually.

[5] This credit amount represents the estate tax payable on US $12,920,000 of total estate value.

[6] We must further assume that you did not make any taxable gift of U.S. situs property during your lifetime. U.S. gift tax is beyond the scope of this article.

[7] This legal form of ownership is to be distinguished from joint ownership with right of survivorship and from tenancy by the entirety. Tenancy in common must be specified in the title documentation and it may carry other U.S. implications, including gift tax. You should consult with a specialist for further detail.

[8] Individuals in common-law relationships are treated as single for U.S. tax purposes. A marriage or a legal arrangement tantamount to marriage is required to claim spousal benefits.

[9] The Biden administration is projecting to eliminate this rule. You should exercise caution before planning on this basis.

[10] This comment is directed at situations where the gain would in fact be U.S. taxable, such as on the sale of U.S. real estate property. Certain assets, such as U.S. corporate stock, are not subject to U.S. capital gains tax when disposed of by a non-resident of the U.S.

[11] Connecticut, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington.

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

[13] This certificate is issued by the IRS. It confirms that all U.S. estate tax (if any) has been paid, thus releasing the lien that is otherwise placed on the estate property until the tax is paid in full.

[14] Please note that this is not an exhaustive list and that any strategy should be pursued only with appropriate tax and legal advice.

[15] Transferring marketable investments to an operating company is usually not recommended, as it could jeopardize your Canadian capital gains exemption, in addition to subjecting those assets to the reach of corporate creditors.