CIBC PRIVATE WEALTH MANAGEMENT

U.S. ESTATE TAX PLANNING FOR CANADIANS

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If you or your family members own U.S. assets or are U.S. persons[1], U.S. federal transfer taxes (estate tax, gift tax, and generation-skipping transfer tax)[2] may apply. And, the Biden Administration's proposals to return to 2009 transfer tax levels[3] could soon significantly increase these taxes. With planning, however, you may be able to arrange your affairs to pay less tax than without planning.

U.S. transfer taxes may arise when assets are transferred to others during lifetime or upon death. For Canadians who are not U.S. persons, U.S. transfer taxes generally apply only to transfers of certain U.S. assets, often referred to as "U.S situs property." Common types of U.S. situs property include U.S. real estate, U.S. securities (held in both registered and non-registered accounts), and U.S. business assets.

For Canadian residents that are also U.S. persons, however, these taxes generally apply to transfers of most assets, wherever they are located.

Estate tax

Estate tax applies to the value of assets upon death, at graduated rates that start at 18% and range up to 40% (for the part of the estate over US$1 million) in 2021. The Biden Administration has proposed an increase in the highest estate tax rate, from 40% to 45% (the 2009 rate)[4].

There is a unified credit that provides an estate tax exemption, eliminating estate tax for U.S. persons whose worldwide estate value is not more than US$11.7 million in 2021.[5] For those who are not U.S. persons and who reside in Canada, a prorated unified credit effectively exempts U.S. situs assets from estate tax if the worldwide estate value is not more than US$11.7 million. The Biden Administration has proposed to effectively reduce the estate tax exemption from US$11.7 million to US$3.5 million (the 2009 amount)[6].

EXAMPLE

Suppose your worldwide estate includes a US$5 million house in Florida and US$45 million of Canadian assets, for a total estate of US$50 million. Let's look at what would happen if the full estate value (after estate tax for each generation) passes from you, to your child, to your grandchild and finally to your great grandchild.

[1] For purposes of the U.S. federal transfer taxes, U.S. persons are considered to be individuals who have U.S. domicile, meaning that these individuals have indicated or demonstrated, in the view of the Internal Revenue Service, an intention to make the U.S. their permanent home. U.S. persons also include U.S. citizens.

[2] Transfer taxes may also be imposed by U.S. states (in addition to federal transfer taxes) but are beyond the scope of this report.

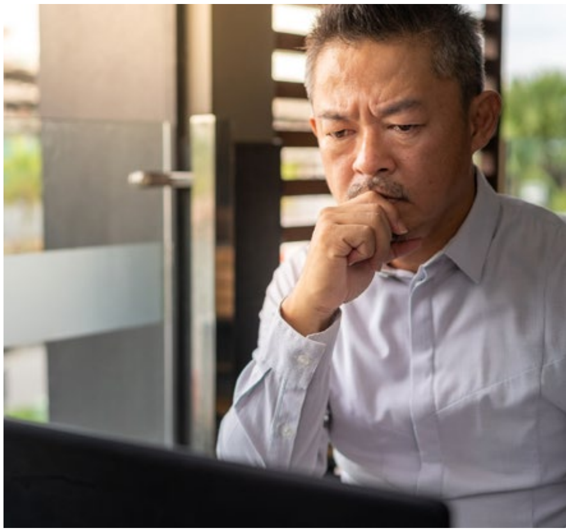
[3] See: joebiden.com/plans-to-support-women-duringcovid19/, which includes a promise to pay for the proposal to permanently provide family, medical, and safe leave as well as sick and safe days by returning the estate tax to 2009 levels.

[4] For estates over US$1 million:
- In 2021 the estate tax rate is 40%.
- In 2009, the estate tax rates were 41% on the estate amount not over US$1.25 million, 43% on the amount over US$1.25 million and not over US$1.5 million, and 45% on the amount over US$1.5 million, as listed in the "Instructions for Form 706" that are available online at irs.gov/pub/irs-prior/i706--2009.pdf.

[5] In 2021, the unified credit of US$4,625,800 provides an exemption from estate tax for estates with values up to US$11.7 million. Married residents may be able to claim a marital credit that may eliminate estate tax if the total value of a couple's estate does not exceed US$23.4 million. Canadian residents who are not US persons may be able to claim a prorated amount of these credits under the Canada-U.S. tax treaty.

[6] A unified credit of US$1,455,800 eliminated estate tax for an estate valued at US$3.5 million, per IRS Publication 950 "Introduction to Estate and Gift Taxes", which is available online at irs.gov/pub/irs-prior/p950--2004.pdf.

Canadian residents who are not U.S. persons



If you are not a U.S. person, estate tax would only be payable on your US$5 million Florida home. It's calculated as the estate tax on US$5 million less a pro-rated unified credit. The credit is pro-rated using the ratio of U.S. situs property (US$5 million) to the value of the total estate (US$50 million). Using the 2021 current exemption of US$11.7 million for 2021, and the current estate tax rates, the potential estate tax bill would be US$1.5 million[7]. Under the Biden Administration's proposals, your estate tax would rise by approximately US$500,000 to US$2 million. If any of your beneficiaries are U.S. persons, additional transfer taxes could arise when they pass away or gift the inherited assets, further eroding the value of the estate.

U.S. persons

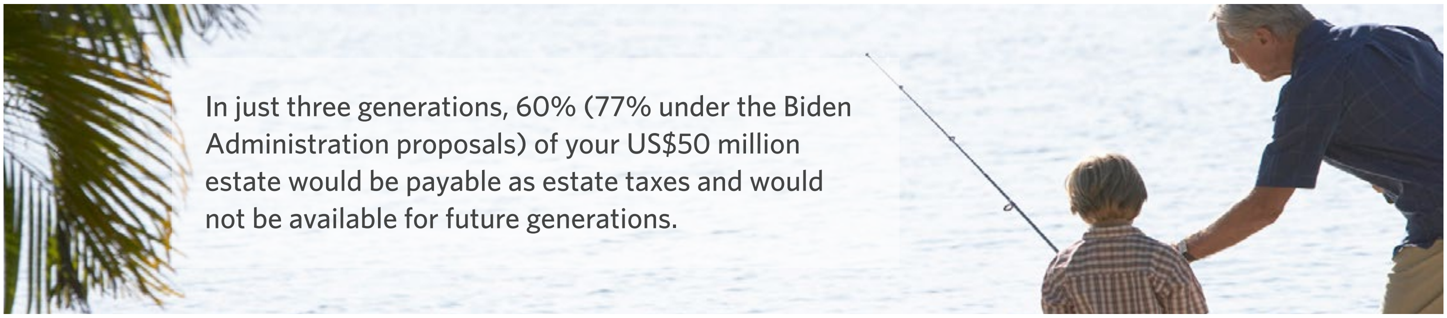
Figure 1 demonstrates the impact that estate taxes may have on wealth that is available for future generations if you, and your children and grandchildren are all U.S. persons.[8]

Figure 1: Tax on a US$50 million estate over three generations, comparing 2021 estate tax to the Biden Administration's proposed estate tax

Family member	2021 estate tax[9] (US$)	Amount available for estate beneficiaries after 2021 estate tax (US$)	Proposed estate tax (US$)	Amount available for estate beneficiaries after proposed estate tax (US$)
You	15.3 million	34.7 million	20.9 million	29.1 million
Your child	9.2 million	25.5 million	11.5 million	17.6 million
Your grandchild	5.5 million	20.0 million	6.3 million	11.3 million
Total	**30.0 million**	**N/A**	**38.7 million**	**N/A**

The first two columns of numbers in Figure 1 show that for your US$50 million estate, the 2021 estate tax bill would be US$15.3 million, leaving an after-tax estate of US$34.7 million for your child. If your child has a US$34.7 million estate, the estate tax bill would be US$9.2 million, leaving an after-tax estate for your grandchild of US$25.5 million. If your grandchild has a US$25.5 million estate, the estate tax bill would be US$5.5 million, leaving an after-tax estate of US$20.0 million for your great grandchild.

The last two columns of numbers in Figure 1 show that under the Biden Administration proposals the combined estate tax for you, your child and your grandchild would increase by US$8.7 million to US$38.7 million, so your great-grandchild would ultimately inherit just US$11.3 million.

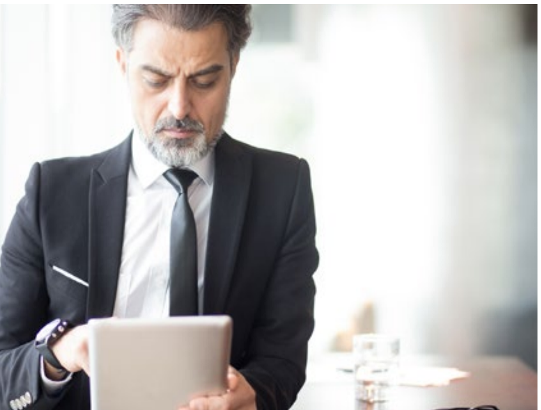


In just three generations, 60% (77% under the Biden Administration proposals) of your US$50 million estate would be payable as estate taxes and would not be available for future generations.

[7] It is assumed that the marital credit is not available.

[8] All figures in the examples have been rounded to up to the next US$100,000. Any effects of inflation have not been considered.

[9] It is assumed that the marital credit is not available. Estate tax for a U.S. citizen has been calculated as the maximum estate tax rate times (the estate value minus the exemption). The maximum estate tax rate is 40% for 2021 (45% under the Biden Administration's proposals) and the estate tax exemption is US$11.7 million for 2021 (US$3.5 million under the Biden Administration's proposals).



Now may be the ideal time for U.S. persons to take advantage of the current US$11.7 million lifetime gift tax exemption, rather than potentially having a much lower exemption of US$1 million if the Biden Administration proposals later take effect. Using the current lifetime gift tax exemption could eliminate up to US$4.8 million of taxes (45% taxes on the estate value between US$1 million and US$11.7 million.) But remember, the gift has to make sense for you, taking into account all considerations, not only taxes.

Gift tax and Generation Skipping Transfer (GST) tax

Canadians who are not U.S. persons may be able to avoid estate tax on some U.S. situs property simply by giving away the property prior to death. Note that this does not apply to gifts of U.S. real estate and U.S. business assets. But if you are a U.S. person, you generally can't avoid estate tax simply by giving your assets away prior to death since there is a gift tax that is integrated with the estate tax. U.S. persons must pay gift tax on the value of most gifts while those who are not U.S. residents must pay gift tax on the value of gifts of certain types of U.S. situs property, including U.S. real estate.

Furthermore, if a U.S. person makes a gift or leaves a bequest to an individual who is more than one generation younger, then GST tax equal to 40% (45% under the Biden Administration's proposals) of the value of the gift will be added to the estate or gift tax bill.

There are some exemptions from gift tax and GST tax. No gift tax applies for any gifts you make to your U.S.-citizen spouse or, if your spouse is not a U.S. citizen, for annual gifts of up to US$159,000 (2021 amount). There is also an annual gift tax and GST tax exemption for total gifts up to US$15,000 (2021 amount) that you make to any recipient. Finally, if you are a U.S. person, there is also a gift tax and GST tax exemption of US$11.7 million (2021 amount) for total gifts you make during your lifetime, which reduces the exemption that is available upon death, though the Biden Administration proposals could reduce the lifetime gift tax exemption to US$1 million.[10]

Strategies to reduce the impact of transfer taxes

Given the high amounts involved, it can be worthwhile to explore strategies that may potentially reduce the impact of U.S. transfer taxes. You should consult with tax and legal advisors in all relevant jurisdictions (such as municipalities, provinces, territories, states, and countries), preferably prior to implementing any strategies. Be sure to consider current (and potential future) jurisdictions where the owners and potential recipients of assets reside, as well as where the assets are (or may be) located.

General strategies

Life insurance

Buying life insurance may provide funds to pay any estate tax liability arising at death. Note, however, that the insurance death benefit will increase the value of the worldwide estate, which may increase the amount of estate tax payable. When the insurance death benefit will be significant, consider holding the policy in a life insurance trust.

Consider making gifts during your lifetime

Consider giving away assets during your lifetime to decrease your worldwide estate value, which may reduce or eliminate the estate tax. If you are not a U.S. person, you can also consider giving away U.S. situs assets (other than U.S. real estate) during your lifetime to eliminate assets that would otherwise give rise to estate tax upon your death.

When planning for gifts, consider taxes that could apply for gifts in the U.S. and Canada[11] (or other jurisdictions) and whether you may use any gift tax exemptions to shelter gifts from tax. And be aware that recipients of your gifts might also face taxes themselves when they later transfer their assets.

[10] Though Joe Biden's campaign website only promised to reduce the estate tax to 2009 levels, it is assumed that the GST and gift tax would also return to 2009 levels. A unified credit of US$345,800 eliminated gift tax for total gifts of US$1 million in 2009.

[11] Although Canada does not have a gift tax, there could be tax on capital gains, attribution of income and gains, or other tax considerations.

Gifting to both U.S. persons and those who are not U.S. persons

If you would like to gift your assets to family members, either during lifetime or upon death, consider transferring U.S. situs assets to any family members who are U.S. persons and non-U.S. situs assets to non-U.S. beneficiaries. The U.S. persons will likely face U.S. transfer taxes at a later date on any property they receive from you (including U.S. situs assets). On the other hand, U.S. transfer taxes may not apply to family members who are not U.S. persons if they receive only non-U.S. situs assets from you.

Dynasty trusts

Rather than leaving your assets directly to U.S. beneficiaries, it may be preferable to create what's often referred to as a "dynasty trust." While assets are held in a dynasty trust, they are not owned by the trust beneficiaries and, therefore, no transfer taxes apply in the hands of the beneficiaries.

To create a dynasty trust, you would transfer your assets, either during your lifetime or under your will, to a trustee who will manage the assets in accordance with the terms of the trust on behalf of the U.S. beneficiaries. The trust's beneficiaries may include individuals who are not yet born (such as future descendants), or a class of beneficiaries (such as grandchildren). This permits flexibility to include future beneficiaries. Transferring assets to a trust during your lifetime may also help to avoid probate fees that would apply to your estate upon death.

Gift tax and GST tax may apply for transfers of assets to a trust, so U.S. persons should consider taking advantage of the current US$11.7 million lifetime tax exemption, as discussed previously.

More information on dynasty trusts is available in our report Heir un-apparent: Estate planning for U.S. beneficiaries.[12]

Strategies if you are not a U.S. person

Choose investments that are not U.S. situs property
Rather than investing directly in U.S. securities, you may wish to invest in non-U.S. investment funds (such as Canadian mutual funds, segregated funds or exchange-traded funds) that hold underlying investments in U.S. securities.

Move physical/collectible assets from the U.S.
U.S. situs assets may include valuables (such as artwork, antiques, jewelry or vehicles) that you keep in the U.S. The simplest way to avoid estate tax for these items is to physically move them out of the U.S.

Sell U.S. situs assets during lifetime
U.S. gift or estate taxes will not apply when you sell U.S. situs assets, although you may pay tax on capital gains for appreciated assets that you sell. You can then use the proceeds to invest in assets that are not U.S. situs (such as Canadian funds), to reduce or eliminate assets that attract estate tax when you pass away.

[12] This report is available online at cibc.com/content/dam/personal_banking/advice_centre/protect-whats-important/us-estate-planning-en.pdf.

Non-recourse debt
U.S. real estate may be financed using non-recourse debt, which is secured by the property and where the borrower is not personally liable if the proceeds of sale of the property is not sufficient to pay the debt. This can reduce the value of your U.S. property for estate tax purposes. In practice, non-recourse debt may be difficult to source and is usually accompanied by higher mortgage interest rates.

Canadian corporation
Estate tax may not apply to property held in a Canadian corporation; however, a number of potential income tax issues (such as shareholder benefit issues and post-mortem planning concerns in Canada, and less favourable U.S. tax rates on long-term capital gains), make this less attractive for U.S. real estate. A Canadian corporation may be appropriate for holding other types of U.S. situs assets, such as U.S. individual securities.

Discretionary trust resident in Canada
A U.S. vacation property may be acquired and owned by a discretionary trust that is resident in Canada. In a typical scenario, one spouse contributes funds to the trust and the non-contributing spouse (and sometimes their children) are named as beneficiaries. The beneficiaries may enjoy the vacation property without exposing it to the estate tax at their deaths and can allow the contributing spouse to use the property as well.

Unlike a corporation, the trust can access favourable U.S. tax rates on long-term capital gains. If the vacation property is still owned by the trust on its 21st anniversary, under Canadian tax law, accrued capital gains may be taxed in the trust for Canadian tax purposes at that time or the trustee may distribute the property to beneficiaries on a tax deferred basis. This is often a theoretical concern, as properties are often sold (upsized or downsized) prior to the 21st anniversary of the trust.

Conclusion

Advance planning may help to reduce transfer taxes, potentially leaving millions of dollars more for future generations to enjoy. U.S. transfer taxes and the strategies that may be used to lessen their impact are complex. You should consult with tax and legal advisors, both in the U.S. and any other jurisdictions where you or your family members (could) reside or have financial interests, prior to implementing any strategies.

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