

Estate & Tax Law

Protocol to U.S.-Canadian Income Tax Treaty Resolves Conflicts in Death Tax Systems

By Michael E. Silverman

The United States and Canada addressed conflicts between their respective death tax systems by entering into a third Protocol (the "Protocol") to the 1980 United States-Canada Income Tax Convention (the "Treaty"). The Protocol, which was ratified on March 17, 1995, added a new Article XXIXB to the Treaty that has significantly reduced the death tax burdens of Canadians and Americans engaged in cross-border transactions. The provisions of the Protocol bring into focus new estate planning issues for citizens and residents of Canada and the United States.

Death Tax Systems

Canada abolished its estate tax system in 1971. Under Canada's income tax laws, however, Canadian residents are deemed to have disposed of all of their assets just before death, and their estates are subject to Canadian income tax on the gains inherent in such assets at death. Additionally, nonresident decedents are deemed to have sold certain of their Canadian-situs assets just before death, and their estates are subject to Canadian income tax on the gains inherent in such assets at death.

The United States subjects U.S. citizens and resident aliens to an estate tax based on the value of their property (regardless of location) at the time of death. This tax is imposed at rates ranging from 37 to 55 percent. The estate of a U.S. citizen or resident is, however, entitled to claim a \$211,300 credit against the

estate tax (the "Unified Credit") which offsets the estate tax otherwise payable on \$650,000 of property. This exemption will increase to \$675,000 in 2000.

The United States also subjects nonresident aliens to estate tax on the value of certain property located in the United States at the time of death. Nonresident aliens are entitled to claim only a \$13,000 credit against the U.S. estate tax; the credit offsets the estate tax otherwise payable on \$60,000 of property.

Prior to the ratification of the Protocol, the estates of Canadian and U.S. residents were required to pay both Canadian income tax and U.S. estate tax on the same property.

Tax Relief Offered by the Protocol

The provisions of Article XXIXB of the Treaty have significantly reduced the tax burdens imposed on the estates of Canadian and U.S. residents. The highlights of Article XXIXB are as follows:

Pro Rata Unified Credit Paragraph 2 of Article XXIXB provides the estates of those Canadian residents who were not U.S. citizens at death with a credit (the "Pro Rata Unified Credit") against U.S. estate tax equal to the greater of the product of: (i) the Unified Credit; and (ii) a frac-



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tion, the numerator of which is the value of the deceased individual's U.S.-situs property and the denominator of which is the value of the deceased individual's worldwide gross estate or the nonresident alien credit.

For example, if a nonresident alien died with \$500,000 of U.S.-situs property and a worldwide gross estate of \$2,000,000, the individual's estate would be entitled to claim a Pro Rata Credit of \$52,825 $((\$211,300 \text{ Unified Credit}) \times (\$500,000 / \$2,000,000))$. In this case, the decedent's executor would elect to use the Pro Rata Credit since it would be greater than the nonresident alien credit (\$13,000).

Spousal Credit Paragraph 3 of Article XXIXB provides certain estates with a marital credit against U.S. estate tax for certain transfers of property to a surviving spouse. This marital credit is in addition to the Pro Rata Credit and is equal to the lesser of: (i) the amount of the Pro Rata Credit available to the estate under Paragraph 2 of Article XXIXB; and (ii) the amount of U.S. estate tax that would otherwise be imposed on the property transferred to the surviving spouse. This marital credit is available to an estate only if the following conditions are satisfied:

1. At the time of death, the decedent was either a U.S. citizen or a U.S. or Canadian resident.
2. At the time of death, the decedent's spouse was a U.S. or Canadian resident.
3. If both the decedent and the surviving spouse were U.S.

residents, one of them was a Canadian citizen.

4. The property transferred to the surviving spouse would have qualified for the estate tax marital deduction under U.S. law if the surviving spouse had been a U.S. citizen and all applicable elections specified under U.S. law have been properly made.
5. The executor of the estate elected the benefits of the Treaty and waive the U.S. estate tax marital deduction.

Credit for U.S. Death Taxes Paragraph 6 of Article XXIXB provides estates of Canadian residents with a Canadian income tax credit for the total amount of U.S. estate taxes and state inheritance taxes imposed with respect to their U.S.-situs property.

Credit for Canadian Income Taxes Paragraph 7 of Article XXIXB provides estates of U.S. residents and citizens with a U.S. estate tax credit for all Canadian and provincial income taxes imposed at death with respect to their Canadian-situs property. This tax credit is subject to the limitations set forth in the Internal Revenue Code regarding the creditability of foreign death taxes.

Small Estate Exception If a Canadian resident's worldwide gross estate at death does not exceed \$1,200,000, then, pursuant to Paragraph 8 of Article XXIXB, the estate will only be required to pay U.S. estate tax on the decedent's U.S.-situs real property. If the decedent's

worldwide gross estate has a value in excess of \$1,200,000, the estate will be subject to U.S. estate tax on all of its U.S.-situs property (stocks, tangible property, etc.).

Estate Planning Issues and Conclusion

The tax relief provisions of the Protocol should cause those Canadian residents who are not U.S. citizens to carefully consider the titling of their U.S. real estate investments. Prior to the Protocol, Canadian investors avoided paying U.S. estate tax on U.S. real estate by transferring title to the real estate to a Canadian corporation. Section 2104 of the Internal Revenue Code exempts from the U.S. estate tax shares of stock of a foreign corporation which are held by a nonresident alien. While this structure will prevent the real estate from being subject to U.S. estate tax, (i) the corporation and its shareholders (upon receiving distributions from the corporation) may be required to pay significant U.S. and Canadian income taxes when the real estate is sold and (ii) the Canadian resident's estate will be required to pay Canadian income tax on the deemed disposition of the stock in the corporation at the individual's death. The Protocol provides significant tax credits to offset the U.S. estate tax that may be imposed on these real estate investments, and it may no longer be appropriate to have title to such investments vested in a special purpose entity.

Canadian residents also need to identify the assets that will be included in their estates for purposes of the Treaty. A Canadian resident's gross estate will be computed under U.S. federal estate tax principles. Under these principles, a Canadian resident's estate will include such assets as insurance policies that the individual owns on his or her life and property which the individual transferred but retained certain beneficial interests in (e.g. income rights in an investment). Inclusion of such assets in the individual's estate could (i) disqualify the individual for the Treaty benefits provided to individuals having a worldwide gross estate not exceeding \$1,200,000 and (ii) reduce the percentage of the individual's property situated in the United States and thereby reduce the individual's Pro Rata Credit.

The Protocol has brought about a significant reduction in the death tax burdens of Canadians and Americans who own property in the two Treaty countries. Many estate plans were developed prior to the Protocol, and Canadian and American residents should carefully assess the tax consequences of their estate plans in light of the Protocol.

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