

The U.S. TAXFAX

**TOPIC: U.S. GIFT AND ESTATE TAXES
FOR U.S. CITIZENS LIVING IN CANADA**

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This edition of the U.S.TAXFAX will discuss the U.S. gift tax and estate tax rules applicable to U.S. citizens residing in Canada.

Gift Taxes:

Gift taxes apply to inter vivos transfers of property and are imposed on the value of gifts made in a calendar year which exceed the exclusion amounts. The **exclusion amount** for a gift to a non-resident alien spouse is \$100,000 per calendar year while the exclusion amount for anyone else is \$10,000 per year. Gifts between resident alien (e.g. U.S. citizen) spouses are never subject to gift taxes.

Gift taxes are calculated using the same tax rate schedules and marginal rates as estate taxes. These rates range from 18% for taxable gifts under \$10,000 to 55% for those in excess of \$3,000,000. Lifetime gifts are accumulated on each gift tax return and taxed at the relevant marginal rates. Gift taxes paid in prior years are then deducted from the gross liability to arrive at the net gift tax liability for the current gift.

As discussed throughout, the gift and estate tax systems are linked together. For example, a U.S. citizen is allowed a once in a lifetime unified credit which effectively exempts the first \$625,000 (increased to \$1,000,000 by the year 2006) of taxable gifts made during the U.S. citizens lifetime from gift taxes. However, the unified credit available on the decedent's estate tax return is effectively reduced by the credit claimed by the taxpayer to shelter gift tax liability during his lifetime. It should be noted that

non-resident aliens are not eligible to use the unified credit to reduce gift tax liability and thus gifts of tangible U.S. property in excess of the exclusion amount are generally taxable.

Filing Requirements:

If gifts are made in a calendar year in excess of the exclusion amounts, a gift tax return (Form 709) must be filed. The return is due by April 15 of the year following the calendar year when the gift(s) was made. An extension of time to file Form 709 can be obtained by filing the necessary form on or before the original due date of the return.

Estate Tax:

Estate tax is the second component of the U.S. transfer tax system. Included in a U.S. citizen's gross estate is the fair market value on the valuation date of all property, real or personal, tangible or intangible, wherever situated. The valuation date is either the date of death, or if elected, six months after the date of death. Property includes, amongst other things, a U.S. citizen's principal residence, the fair market value of life insurance policies, RRSPs and other investments. It also includes the market value on the valuation date of any gifts made within three years of the date of death. The gross estate is then reduced by allowable deductions to arrive at the taxable estate. Allowable deductions include funeral and administration expenses, accounting fees, and debts of the taxpayer.

Total tentative tax is then calculated on the sum of:

- the taxable estate, plus
- the amount of adjusted taxable gifts made by the decedent after December 31, 1976.

The adjusted taxable gifts do not include annual gifts that are below the exclusion amounts mentioned above, or gifts made within three years of the date of death as these gifts are already included in the gross estate. However, the adjusted taxable gifts made after 1976 and up to three years preceding death are included in the estate at the value reported for gift tax purposes and not the value on the valuation date. In order to fully integrate the gift and estate tax systems, any gift taxes paid by the decedent after December 31, 1976 are deducted from the tentative estate tax liability to arrive at the gross estate tax.

Credits such as the unified and foreign death tax credit then reduce the gross estate tax. A U.S. citizen's estate is allowed a unified credit which effectively shelters the first \$625,000 of the taxable estate from estate taxes. The estate is also allowed a credit for foreign death taxes paid on property included in the estate.

The Canada - U.S. tax treaty clarifies that Canadian income taxes paid on the terminal return of Canadian residents, who are also U.S. citizens, will be considered foreign death taxes for U.S. estate tax purposes. As a result, the estate may receive a credit for Canadian taxes paid on the deemed disposition of **Canadian** property at death. Of further note is the treaty also provides that Canada may allow a foreign tax credit on the final return for U.S. estate taxes paid on U.S. property.

Filing Requirements:

If the gross value of the estate is greater than that which can be sheltered by the unified credit (i.e. 625,000 for 1998 and rising to \$1,000,000 by 2006), the executor must file an estate tax return (Form 706) within 9 months of the date of the death. An extension to file the return may be obtained by filing Form 4868.

Estate tax planning:

One of the most popular methods used to minimize estate taxes is gifting property to beneficiaries before death. When making inter vivos gifts, the U.S. gift tax rules and the Canadian gifting and attribution rules should always be considered. U.S. citizens may gift up to \$100,000 per year to their non U.S. citizen

spouse (subject to certain restrictions), and \$10,000 per year to anyone else (e.g. their children), without any U.S. gift tax consequences. For example, parents may gift tax-free up to \$20,000 annually (\$10,000 each) to each of their children under this provision.

Another common planning opportunity concerns the principal residence. In the U.S., gain on the sale of a principal residence is subject to income tax (new rules may now exempt up to \$250,000 of capital gain from U.S. income tax). Furthermore, if a principal residence is owned at death, the fair market value of the property is included in the decedent's estate. As a result, if a Canadian principal residence is jointly owned by a U.S. citizen and a non-U.S. citizen spouse, consideration should be given to gifting the asset to the non-U.S. citizen under the \$100,000 tax-free spousal gift provision. Ownership in this manner solves both the income tax and estate tax problems at the same time.

Miscellaneous:

Cost Basis of Property Received:

The U.S. cost basis of property received differs depending on whether the property was received as a gift or from an estate. If a person receives a gift, the cost basis will normally be equal to the lesser of the property's fair market value, or the giftor's cost basis at the time the gift was made. This basis is then increased by the amount of gift taxes paid. If a person receives property from an estate, the cost basis will normally be the property's value for estate tax purposes.

We recommend that as a precautionary measure, accountants should consider whether U.S. gift and estate tax rules apply when advising clients on Canadian tax matters.

Please remember that the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained herein.