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U.S. Estate Tax: An Update

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On December 17, 2010, the U.S. Congress passed and signed the *Unemployment Insurance Reauthorization and Job Creation Act of 2010* (UIRAJC). This Act includes, among others, certain highly-anticipated provisions regarding the application of estate tax after 2010. The Act also impacts the gift tax provisions and generation-skipping transfer tax. The purpose of this Bulletin is to highlight the changes to the estate tax as a result of the UIRAJCA (hereafter, the "Act")[1].

Former rules

The former rules, which were established in 2001, provided for a gradual accrual of the exemption[2] amount allocated in addition to a reduction of the top marginal tax rate until the complete abolition of estate taxes as of January 1, 2010.

It was provided that in the absence of legislation to the contrary, the rules that were effective in 2001 would be reinstated on January 1, 2011. Thus, the exemption amount would be reduced from $3.5 million to $1 million and the top marginal tax rate would increase from 45% to 55%. The effect would have been catastrophic for estate tax planning implemented prior to this period.

New rules

Retroactive application to January 1, 2010

The new legislation has a number of effects. First, it retroactively reinstates estate taxes and generation-skipping transfer taxes to January 1, 2010.

Election for decedents who died in 2010

It then offers estate executors the election of excluding the estate of a decedent who died in 2010 from being subject to estate tax.

Increased basic exemption

The Act increases the basic exemption from a total of $3.5 million in 2009 to $5 million. This exemption applies to estate taxes, generation-skipping transfer taxes as well as gift taxes.

The Act also provides an indexation of the basic exemption in 2012.

Marginal tax rate reduction

The top marginal tax rate, which was 45% in 2009, has been lowered to 35%[3] for estate taxes as well as for gift taxes and generation-skipping transfer taxes; however, the applicable rate on the latter tax is still set at 0% for the year 2010.

Portability provision: new rule applicable to spouses

Lastly, a very interesting measure, the "Portability provision" was established. This provision allows a deceased to transfer to the surviving spouse the unused portion of the basic $5 million exemption.

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[1] For more information regarding the general rules on U.S. estate taxes, we refer you to the Tax Bulletin *U.S. Estate Taxes: Also Apply to Canadian Residents* (October 2009), available on the RCGT Web site rcgt.com.

[2] Exemption amount used to calculate the "unified credit".

[3] The "unified credit" therefore totals US$1,730,800 for U.S. residents for estate tax purposes. It should be noted that the concept of residence for estate tax purposes is different from the concept of residence for income tax purposes. We are referring more specifically to the concept of tax domicile in this case. Bear in mind that a U.S. citizen is always considered as being domiciled in the United States.

Rules expiring in 2012

There is, nevertheless, a problem with the new law. The new rules will only apply until December 2012. Hence, in the absence of legislation in this regard, the initial scenario will apply again on January 1, 2013, i.e., the reestablishment of the 2001 rules.

Clarifications regarding the new rules

Tax election for the 2010 taxation year

For decedents who died during the year 2010, the estate executor may either file an estate tax return[4] based on the new rates, or elect to exclude the deceased's estate from the application of estate taxes.

TAXATION UNDER THE NEW RULES

If the estate executor elects to tax the estate according to the new rules, the beneficiaries will inherit the property having a tax cost equal to the fair market value of the property at the time of death.

For individuals who died after 2009 but prior to December 17, 2010, the tax filing and payment date is September 19, 2011[5]. An application to extend this deadline by six months may be made to the tax authorities; however, the law is unclear on this matter.

For individuals who died after December 16, 2010, estate tax returns must be filed and taxes paid in the nine months following the date of death.

ELECTION TO POSTPONE THE APPLICATION OF ESTATE TAXES

If the estate executor would rather elect to postpone the application of estate taxes, the beneficiaries will inherit the property having a tax cost equal to the original cost on the date that the decedent acquired it, on which a gross-up may apply[6].

For U.S. citizens, this election must be made by completing Form 8939 and attaching it the decedent's regular income tax returns[7] by April 18, 2011. The official version of this form, as well as the filing instructions, are not yet available.

Canadian residents who would like to take advantage of this election may have to file an income tax return along with Form 8939. The Internal Revenue Service has not yet expressed an opinion in this regard.

It should be noted that this election is revocable, but only with the express consent of the Secretary of Treasury.

Portability provisions

As previously indicated, an individual who dies after December 31, 2010 and does not use the full amount of the basic exemption may transfer the unused portion to the surviving spouse, thereby reducing the estate taxes triggered upon the second death[8]. It should be noted that this provision is valid only until December 31, 2012 and applies to the exemption amount for estate taxes only.

To take advantage of this transfer, the estate executor must file an election and attach it to the deceased's timely-filed estate tax return, even if the deceased is not required to file an estate tax return. Thus, the Act imposes a filing requirement in order to benefit from the transfer.

The maximum exemption amount that may be transferred to a surviving spouse is $5 million dollars, and this amount is limited to the unused exemption amount of the previous spouse. An individual who has been widowed more than once may use the most recent spouse's available exemption amount only.

To further complicate matters, the exemption received from a first-to-die spouse cannot be transferred, upon the death of the surviving spouse, to that individual's new spouse. Only the unused portion of the deceased's $5 million dollars may be transferred to the new spouse. The amount received from the preceding spouse will be lost. For the time being, there seems to be some ambiguity concerning this matter. It is hoped that, the U.S. government will act soon to clarify the issue.

Impact for Canadian residents having property subject to estate taxes

The new law is entirely applicable to Canadian residents owning property located in the United States and subject to U.S. estate taxes. Therefore, refer to the Tax Bulletin *U.S. Estate Taxes: Also Apply to Canadian Residents* (October 2009) for more information while applying the changes described herein with respect to the basic exemption amount and top marginal tax rate.

Conclusion

Although straightforward in application, the new rules require an in-depth analysis of the decedent's estate in 2011, particularly if the person died in 2010, so as to ensure that the right decisions are made on a timely basis and the estate tax is minimized.

Do not hesitate to contact your Raymond Chabot Grant Thornton advisor who can help you determine if U.S. estate taxes apply to your property and, if they do, suggest ways to minimize their impact.

For more information, go to our Web site: rcgt.com.

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[4] Form 706 (*United States Estate (and Generation-Skipping Transfer) Tax Return*) - *Estate of a citizen or resident of the United States* or Form 706NA *United States Estate (and Generation-Skipping Transfer) Tax Return - Estate of non-resident not a citizen of the United States*).

[5] September 17 being a Saturday.

[6] The permitted gross-up totals $1.3 million, which is allocated at the estate executor's discretion. With regards to transfers to a surviving spouse, an additional gross-up of $3 million is granted. This measure applies to U.S. citizens and individuals domiciled in the United States. As for non-residents, the gross-up is limited to $60,000. For the time being, we cannot determine whether a Canadian resident could benefit from an increase over $60,000. The Internal Revenue Service has not yet expressed an opinion regarding estates held by Canadian residents.

[7] Form 1040.

[8] This measure also applies to gift tax but not to generation-skipping transfer tax.