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Death and taxes in the USA

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One of the most talked-about tax issues south of the border is the future of the U.S. estate tax. The current regime is set to expire at the end of this year.

The issue is of critical importance to two groups of Canadians: U.S. citizens living in Canada and Canadians who own "U.S. situs property."

In Canada, upon death, there is a deemed disposition of your property at fair market value. The resulting increase in value from the date of purchase to the date of death is taxable as a capital gain on your final tax return.

The U.S. system works differently. Instead of a deemed disposition with a potential tax liability upon death, the U.S. imposes an estate tax levied on the fair market value of all property owned on the date of death – not solely the increase in value from date of purchase to date of death.

The U.S. estate tax applies to all U.S.

citizens, even those living outside of the United States, as well as to non-U.S. citizens who die owning U.S. situs property, such as U.S. real estate or stocks in U.S. companies.

For 2009, U.S. estate tax rates begin at 18%, but rise to 45% once the taxable estate is over US\$1.5-million. However, the U.S. tax code provides an exemption to the estate tax, the amount of which depends upon your country of citizenship.

U.S. citizens currently have an exemption for the first US\$3.5-million of the estate which results in U.S. citizens paying taxes at a rate of 45% for any amount in excess of US\$3.5-million.

Canadian citizens who own U.S. assets, on the other hand, are only entitled to a pro-rated exemption under the Canada-U.S. tax treaty. As such, the U.S. estate tax exemption for Canadian citizens is equal to US\$3.5-million multiplied by the ratio of U.S. property to the Canadian citizen's worldwide estate.

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That means if you are a U.S. citizen and your worldwide estate, including your Canadian home, is under US\$3.5-million, you need not worry about U.S. estate taxes. If you are a Canadian citizen, the amount of your exemption for U.S. estate tax purposes will depend upon the value of your U.S. property versus your non-U.S. property. This is the present state of U.S. estate taxes --at least for now.

However, the U.S. estate tax could be repealed for 2010. The status of the estate tax has been in limbo since the entire system was revamped in 2001. Before the reform, the top rate was 55% and the exemption was only US\$675,000. Over the past nine years, the rates have fallen and the exemption has risen.

But given the current state of the U.S. economy, it is unclear what the future holds for the U.S. estate tax regime. Some possible options include:

Do nothing. The U.S. estate tax will disappear in 2010 and automatically return in 2011 with a US\$1-million exemption and a top rate of 55%. But this could be a politically risky move. On the U.S. Tax Policy Center website it has been estimated that with a US\$1-million exemption, approximately 46,000 estates would owe estate tax each year compared with only 6,400 per year by keeping the exemption at its current level.

Another option is to keep the 2009 rates, which max out at 45% with the current exemption of US\$3.5-million. U.S. President Barack Obama has recommended that the exemption be indexed to inflation.

And yet another option, proposed by the U.S. Senate, would cap the top rate at 35%, with an exemption of US\$5-million.

Stay tuned as more details come out late 2009.

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