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Canadian Decedents with US Real Estate

On July 31, 2015, the United States' Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 added new Code sections 1014(f) and 6035. On March 2, 2016, the IRS released related regulations. Under the new rules, the reporting of property values between estates and beneficiaries must be consistent, effective for US estate tax returns that are either required to be or are in fact filed after July 31, 2015.

If a US estate tax return was not filed as required, the new rules presume the inherited property's basis to be zero, even if no US estate tax is otherwise owed. The new rules highlight the importance of knowing when a Canadian resident (who is not a US person) is obliged to file a US estate tax return, and they are likely to be an unpleasant surprise to estate beneficiaries.

Most Canadian practitioners are aware that a Canadian-resident individual who owns US real estate is subject to US estate tax on that property's value. However, a Canadian decedent is subject to US estate tax only to the extent that the value of his or her US-situs property exceeds the credit equivalent amount, because article XXIX B(2) of the Canada-US treaty allows a Canadian decedent a pro rata portion of the US unified credit equivalent (US$5.45 million for 2016). However, many Canadian practitioners are unaware that section 2102 limits the credit equivalent to US$50,000, and the decedent must file a non-resident US estate tax return (form 706-NA, "United States Estate (and Generation-Skipping Transfer) Tax Return") in order to claim this pro rata credit equivalent amount. Under the new rules, the beneficiary's basis is deemed to be zero if this form is not filed.

The regulations issued on March 2, 2016 are broad, detailed, and apply to many situations that a Canadian decedent typically does not encounter. However, for a Canadian resident who is not a US person and who owns US real property, new regulation 1.1014-10(b) limits the new basis consistency requirements of section 1014(f) to property that is (1) included in the decedent's gross estate under section 2031, or (2) subject to tax under section 2106 if the property generates a tax liability that exceeds allowable credits. New regulation 1.1014-10(b)(3) provides that "if a liability under chapter 11 is payable after the application of available credits . . . then the duty of consistency applies to the entire gross estate." Under section 2102(b)(1), the credit equivalent amount is limited to US$50,000 if the decedent is neither a US citizen nor a US resident for estate tax purposes. Furthermore, section 2102(b)(3)(A) allows a non-citizen who is not a US resident for estate tax purposes to claim a pro rata unified credit if he or she is allowed to do so under a treaty. However, treaty article XXIX B(2) allows for a pro rata unified credit "only if all information necessary for the verification and computation of the credit is provided." Neither the treaty nor the Code requires the benefits of article XXIX B or section 2106(b)(3)(A) to be claimed on a timely filed return. Section 6114 generally allows for an individual's treaty benefits regardless of whether a timely election has been made. Moreover, new regulation 1.1014-10(c)(3)(ii) provides that if no return has been filed, the value of the property described in regulation 1.1014-10(b) is zero.

Thus, until the US estate tax return has been filed, the beneficiaries of an estate have no basis in inherited US-situs property, even if no estate tax is otherwise owing. However, when an estate tax return has been filed, the property's basis is adjusted to the value as of the date of death. Thus, failure to file a US estate tax return is especially problematic for beneficiaries who wish to sell inherited US real estate. The result may also be a problem for a beneficiary who inherits income-producing property: having no basis in the property means that he or she cannot deduct tax depreciation until an estate tax return is filed.

The IRS has requested comments on the regulations. Unless and until the regulations are changed, Canadian practitioners should be cognizant of the deemed-nil basis for inherited property if form 706-NA is not filed, even if estate tax is not otherwise payable.

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