US Gift and Estate Tax Law: Addendum on the Impact of the 2013 Tax Act and the Judicial Repeal of the Defense of Marriage Act

EDWARD C. NORTHWOOD
Counsel, Ruchelman P.L.L.C.
Member, STEP Toronto

The US gift and estate tax regime has used the same basic unified system since 1976. In 1981, major changes were introduced, primarily relating to marital deductions. Not only were the types of marital/spousal trusts that give rise to deductions expanded, but the marital deduction was also made unlimited. As a result, it became standard US practice to defer estate taxes until the death of the surviving spouse (which is also the general strategy in Canadian estate planning).

Since 1981, the primary changes to the US transfer tax system have involved increasing exemptions and, under the 2001 legislation, reducing tax rates. The 2001 legislation also phased out the credit for state death taxes. Until 2001, the maximum federal estate tax rate was 55 percent. In reality, however, the maximum rate payable to the United States was only 39 percent because the state death tax credit resulted in the passage of the additional 16 percent to the states. One consequence of the elimination of the state death tax credit was the elimination of state estate and inheritance taxes in most jurisdictions, including Florida, Texas, and California. The state estate or inheritance tax remains separate from the federal estate tax (although it is based on the same principles) in the states that retain it.

In late December 2010, a return to pre-2001 law was averted not simply by an extension of the 2009 exemption and rates but also by an increase in the gift tax exemption from $1 million to $5 million, an increase in the estate tax exemption and generation-skipping tax exemption to $5 million, and a reduction of the maximum tax rate to 35 percent. This band-aid solution was also temporary: the Tax Relief Act of 2010 was signed into law by President Obama on December 17, 2010 and terminated on December 31, 2012. Barring any other changes, this Act would have caused the gift, estate, and generation-skipping tax rules to return to what they would have been in the absence of the 2001 tax reduction legislation.

This two-year law also introduced a concept known as "portability" – that is, when the first spouse dies without using all of the available exemption ($5 million, for example), the surviving spouse may claim the unused portion for both gift and estate tax purposes. Portability of exemption is unavailable to spouses who are neither citizens nor residents of the United States.

Effective January 1, 2013, extensive new tax legislation, the American Taxpayer Relief Act of 2012, was enacted. This statute provided permanence (at least to the extent that any tax law can provide permanence). Among the provisions most relevant to cross-border tax and estate planning are the following:

1) The maximum gift, estate, and generation-skipping transfer tax rates have been raised from 35 to 40 percent. The maximum rate begins for taxable estates over $500,000.

2) The 2011 temporary exemptions have been fixed at $5 million, indexed for inflation retroactive to 2011. Thus, for example, each transfer tax exemption is US$5.25 million in 2013.
3) The state death tax credit for state estate taxes is permanently repealed, and these taxes are deductible for federal estate tax purposes.
4) The highest marginal income tax rates have risen from 35 to 39.6 percent for high-income taxpayers (including US trusts and estates). The threshold is high for individuals (adjusted gross income over US$400,000 for single taxpayers) but low for trusts and estates (US$11,950 in 2013).
5) The maximum tax rates on long-term capital gains and qualified dividends (those issued by most Canadian and US corporations) have risen from 15 to 20 percent, but only for US taxpayers (including non-residents with capital gains on US real property) whose income is above the thresholds mentioned in point 5.
6) Estate tax exemption portability between US married couples has been made permanent (but an estate tax return electing this treatment must be filed on the death of the first spouse).

Another important 2013 development affecting Canadian residents who may be subject to US estate tax (US citizens or non-US citizens who own US situs assets at death) is United States v. Windsor, 570 US (2013). This decision of the US Supreme Court (the highest federal court) held the federal Defense of Marriage Act (DOMA) unconstitutional and therefore void. Under DOMA, which was enacted in 1996, no federal benefits, including tax benefits, were available to same-sex married couples. The judicial repeal of DOMA means that Canadian married same-sex couples may now take advantage of the marital deduction for gift and estate tax purposes, the higher annual exclusion for gifts to non-citizen spouses, exemption portability for US-citizen spouses, and the marital credit under the Canada-US tax treaty.

The 2013 legislation and judicial changes also significantly affect Canadian ownership of US real property and other US situs assets. The large estate tax exemption, which is available under the treaty on a prorated basis, means that individual ownership is an option for all but the wealthiest Canadians. For example, use of the marital credit on the death of the first spouse means that a deceased spouse's estate that includes US situs assets is not subject to non-resident estate taxes, unless the value of the estate's worldwide assets exceeds US$10.5 million.

Moreover, the increase in the income tax rates should not adversely affect Canadian ownership of US real property by individuals or trusts because the 20 percent maximum capital gains tax rate is less than the corresponding Canadian combined federal and provincial rate. Since the US tax is creditable against the Canadian tax, the overall taxes paid should remain the same in most cases. ■