CROSS-BORDER ESTATE PLANNING: CANADIAN PARENTS OF U.S. CHILDREN

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U.S. transfer taxes (U.S. gift, estate and generation skipping taxes) should be a concern to any practitioner creating an estate plan with U.S. links. The following article addresses U.S. estate tax consequences of a family comprised of Canadian citizen/resident parents with American children.

IN GENERAL

Transfer tax is imposed on the fair market value of the property transferred, reduced by any consideration received.

U.S. citizens, and non-U.S. citizen individuals that are domiciled in the U.S., are subject to the U.S. transfer tax system on global assets.

A person acquires a domicile in a place by living there, for even a brief period of time, without the presence of a definite intention to leave.

A facts and circumstances test is used to determine domicile. Factors include, *e.g.*:

1. Statements of intent (as reflected, *e.g.*, on tax returns filed, visa application, and similar evidence);
2. Time spent in U.S. versus time spent abroad;
3. Visa status (*e.g.*, green card holder);
4. Ties to the U.S. versus abroad;
5. Country of citizenship;
6. Location of employment, business, and assets;
7. Other indicators such as voting, affiliations, membership, driver license, and similar items.

Residence without the intention to remain indefinitely will not constitute a domicile, and the intention to change domicile will not effect such a change unless accompanied by actual relocation.

On the other hand, non-resident, non-citizens ("N.R.N.C.'s") (*i.e.*, nonresident aliens that are not domiciled in the U.S.), such as Canadian citizens and residents, are only subject to the U.S. transfer tax system on U.S. situs assets (see discussion below) that are given away during their lifetimes or upon their death.

Thus, the U.S. estate tax minimization planning covered in this article addresses both U.S. estate taxation as it may apply to U.S. situs assets owned by N.R.N.C.

*This article was edited by Edward C. Northwood parents, as well as the U.S. child's exposure to U.S. estate tax on the worldwide assets that are accumulated during their lifetimes (including what they may receive as inheritance from their parents).

U.S. ESTATE TAX BASICS

U.S. Citizen or Domiciliary

The U.S. estate tax base (the "gross estate") of a U.S. citizen or resident includes the value of all personally owned property as well as assets, comprising certain trusts and similar structures, that may not be effectively excluded from the estate tax base because the decedent retains an interest in the property at the time of death. If the asset is located outside the U.S., a foreign tax credit may be claimed for the amount of any estate, inheritance, legacy or succession taxes actually paid to a foreign country in respect of any property situated within that foreign country and included in the gross estate of the decedent under foreign law.

N.R.N.C.

In General

The gross estate for an N.R.N.C., on the other hand, is comprised solely of U.S. situs assets that would be included in such decedent's estate under general estate tax rules. The gross estate tax value is reduced by various deductions to arrive at a taxable estate. Examples of the main deduction items include gifts to a surviving spouse or a spousal trust (the "marital deduction"), gifts to charities, debts of the decedent, and estate administration expenses. In the case of an N.R.N.C. estate, the eligibility of the marital and charitable deductions is more restricted and other deductions are allowed only in proportion to the value of the U.S. situs assets over the value of the worldwide assets.

U.S. Situs Assets

As noted above, only assets deemed situated in the United States (*i.e.*, U.S. situs assets) are included in the N.R.N.C. decedent's gross estate and are subject to U.S. estate tax. U.S. real estate and tangible personal property located within the United States are considered U.S. situs assets for both U.S. gift and estate tax purposes.

With respect to intangible property, U.S. situs assets include stock issued by a domestic corporation and debt obligations of a U.S. person, the U.S. and any state or political subdivision thereof, or the District of Columbia. For U.S. situs purposes, it is only relevant as to where the company is organized, not where the shares are traded or located. Therefore, it is important for N.R.N.C.'s to note that shares of stock of American companies, such as Coca-Cola or Apple, are considered U.S. situs assets.

> **Example 1**: John, a Canadian citizen, resident and widower, owns shares of Facebook valued at $6,000,000. The shares are located in a brokerage account in Montreal and the title is in John's personal name. Absent any credits or deductions, John will be subject to the U.S. estate tax on his shares of Facebook at the conclusion of his lifetime.

Non-U.S. situs assets include proceeds of life insurance, bank deposits, debt obligations generating portfolio interest under Code §871(h)(1), and works of art on loan in the United States for exhibition purposes at the time of the N.R.N.C. owner's death.

The situs of a partnership remains unclear. In the absence of a Treaty provision, authorities will analyze the situs of the underlying assets of a partnership to make a determination. Additionally, the I.R.S. has held situs of a partnership to be where the business of the partnership is carried out.

Under the U.S.-Canada Treaty, there exists is a reciprocal foreign death tax credit. Thus, upon death, if a Canadian has a Canadian capital gains tax on a U.S. situs asset (due to a deemed disposition on death) and also has a U.S. estate tax on the same U.S. situs asset, the U.S. estate tax may offset the Canadian federal tax due.

> **Example 2:** Aline, a Canadian widow, passes away, holding shares of SallyCo, a company organized in the U.S. The shares (held in a brokerage account in Montreal) have appreciated in value from $1,000,000 to $2,000,000 when the Aline passes away, and thus, a capital gains "death" tax is due in Canada. Aline's worldwide estate is valued at over $6,000,000. Aline's estate will receive a credit on her Canadian capital gains tax due for the U.S. estate tax paid on the shares of SallyCo.

Since the U.S. estate tax is often higher than the Canadian capital gains tax, there may still be some U.S. estate tax due. Further, some Canadian provinces do not recognize the U.S. estate tax death credit. Therefore, there may be some "double taxation" with regard to Canadians residing in these provinces.

U.S. ESTATE TAX: EXEMPTION AMOUNT

U.S. Citizen or Domiciliary

The lifetime gift/estate tax exemption for U.S. domiciliaries/citizens ("U.S. individual(s)") is $5,000,000, indexed for inflation beginning in 2011. Thus, U.S. individuals may transfer $5,000,000+ free of U.S. gift tax during life, but the lifetime usage of the $5,000,000+ exemption will offset the $5,000,000+ available at death. Cumulative lifetime taxable gifts are added to the taxable estate in order to unify the gift and estate tax system.

For 2014, the exemption amount is $5.34 million resulting in a unified tax credit of $2,081,000.

Year	Exemption Amount	Tax Rate Range	Unified Credit
2014	$5,340,00	18-39% on first $1 million, then 40% rate on excess	$2,081,800

For 2014 and thereafter, the graduated estate tax rates on taxable estates are as follows:

From	To	Initial Tax	Rate on Excess
$0	$10,000	0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,300	39%
$1,000,000	And over	$345,800	40%

N.R.N.C.

In General

N.R.N.C.'s are generally allowed a reduced estate tax exemption amount of only $60,000 for a limited unified credit of $13,000. However, this amount may be increased by an applicable tax treaty.

Treaty Benefits: U.S.-Canada Tax Treaty

The U.S.-Canada Tax Treaty (the "Treaty") provides that Canadian residents that are not U.S. citizens will, in general, be able to claim the same exemption amount ($5.34 million in 2014) that U.S. citizens and domciliaries may claim. However, the exemption is prorated based on the ratio of value of U.S. situs assets over worldwide assets.

> **Example 3:** Ruth is a Canadian citizen and resident and passes away in 2014. She owns a condo in Florida valued at $500,000 but her worldwide estate is valued under $5,340,000. Consequently, Ruth will not have a U.S. estate tax on death provided her estate files a non-resident return and makes a treaty election. The same result would occur if Ruth was a U.S. individual.

"The U.S.-Canada Tax Treaty…provides that Canadian residents that are not U.S. citizens will, in general, be able to claim the same exemption amount ($5.34 million in 2014) that U.S. citizens and domciliaries may claim."

> **Example 4:** Ruth is a Canadian citizen and resident and passes away in 2014. She owns a condo in Florida valued at $1,000,000, but her worldwide estate is valued at $10,000,000. The U.S. estate on the $1,000,000 is $345,800; however, the Treaty allows a credit of $208,180 (10% of $2,081,000).

Marital Credit

Upon death of the first spouse, there also exists a marital credit under the Treaty. This effectively *doubles* the pro-rated applicable credit amount (*i.e.*, exemption). The marital credit is available if property passes to an N.R.N.C. in a way that would have qualified for the U.S. marital deduction (either outright or in a marital trust). The marital credit is only available if the estate foregoes use of the marital deduction that passes to a Qualified Domestic Trust ("Q.D.O.T.").

> **Example 5:** The facts are the same as Example 4, but Ruth leaves everything to her spouse, a Canadian resident. Upon her death, the U.S. estate tax will be entirely eliminated, as there will be a marital credit of $137,620.

Martial Trust

As with the Canadian deemed disposition tax on death, the estate tax may be deferred until the death of the second-to-die of a married couple. The use of a spousal trust/marital trust with an "ascertainable standard" can allow the surviving spouse the ability to access income while excluding the assets of the spousal trust from his/her gross estate.

> **Example 6:** Pauline, a married Canadian citizen/resident has an estate of $9,000,000. Her spouse, Phillipe, also a Canadian citizen/resident has an estate valued at $1,000,000. Pauline also has title, in her sole name individually, to a townhouse located in Tampa, Florida, valued at $1,000,000. Upon her death, Pauline has the option of leaving the townhouse directly to Phillipe or alternatively to leave the townhouse to Phillipe through the use of a spousal trust/marital trust with an "ascertainable standard" clause. If Pauline does not use a spousal trust in her will and Phillipe receives the assets outright, Phillipe will have a gross estate of $10,000,000 and the Florida townhouse will be subject to U.S. estate tax upon his death.

PLANNING FOR CANADIAN PARENTS WITH U.S. CHILDREN

Canadian Parents

As N.R.N.C.'s, the parents will only be subject to U.S. estate tax on U.S. situs assets. Therefore, to avoid U.S. estate taxation, direct ownership of U.S. situs assets should be avoided (unless the pro-rated Treaty exemption will completely shelter such assets from estate tax). Examples of "blocker" entities include Canadian holding companies and certain irrevocable trusts.

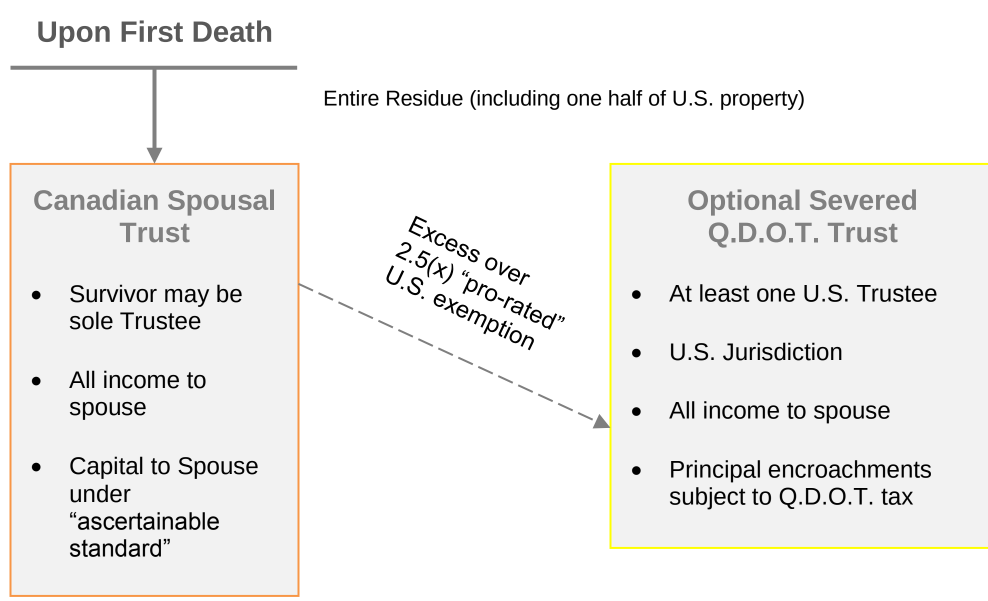
Marital Deduction

Where estate tax would exist on the death of the first spouse and the exemption, even after including the marital credit, is insufficient to preclude such tax, a marital deduction must be used. Since the surviving spouse is an N.R.N.C., the deferral can only be obtained through a Q.D.O.T. In general, for a qualified Q.D.O.T, the surviving spouse must be the only beneficiary during his/her lifetime and must receive all income of the trust. Further, there must be a U.S. trustee, and the trust must be subject to a U.S. jurisdiction. Thus, clients should realize that the use of a Q.D.O.T. may limit flexibility if employed, due to these administrative/logistical requirements.

Design

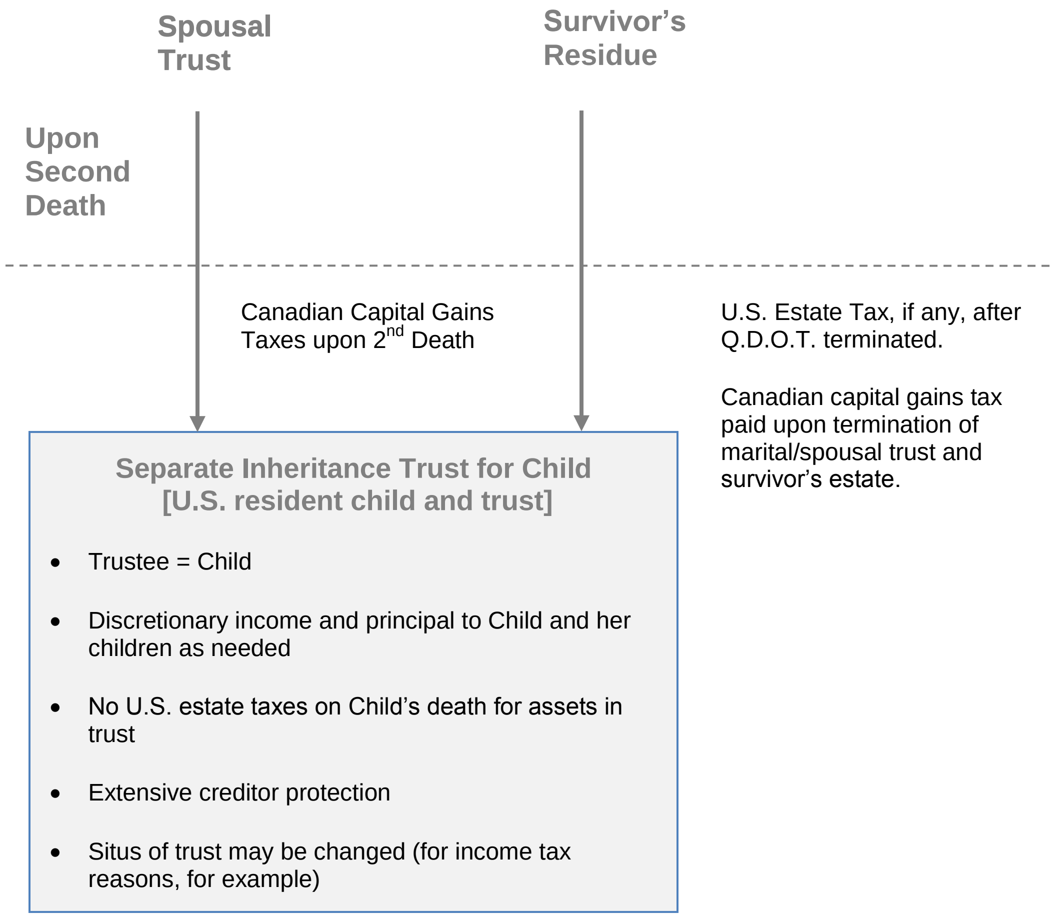
So, what should the cross-border planning process entail and what should the recommendation be? The first step is to work with the Canadian trusts and estate lawyer when he/she drafts the parents' wills. The next step is to determine whether the Canadian parents have a possible U.S. estate tax. If they do, the estate plan should apply the Treaty pro-rated unified credit while maximizing flexibility for the client through the application of marital credit in conjunction with a marital/spousal trust. While a Q.D.O.T. *could* be appropriate, the estate of the first deceased spouse would lose the marital credit. Therefore, the Q.D.O.T. should remain an option, but not a certainty, in the drafting of the will and should only be used if the first spouse to die had a worldwide estate of more than twice the amount sheltered by the two applicable credit amounts, taking into account the use of death tax credits and the allowable estate tax deduction (other than the marital deduction).

The first diagram demonstrates the estate plan of the first parent to pass away.



U.S. Children

Unlike the parents, the U.S. children will have their lifetime gifts and worldwide estate taxed at death (not just their U.S. situs assets). An "inheritance trust/dynasty trust" is a trust that exists for a child's lifetime, drafted so that the value of the trust is excluded from the child's estate upon his/her death. Thus, upon the death of the second spouse, the assets from the combined estate should be distributed to a separate inheritance trust for each child and descendant.



Final Diagram

The full plan is diagramed as follows: