



## Wealth Management Services

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### Tax and Estate Planning for U.S. Citizens in Canada

Maximize your wealth by utilizing tax and estate strategies on both sides of the border

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*The United States is one of the few countries in the world that taxes its citizens on worldwide income during their lifetime no matter where in the world they live. They also tax the U.S. citizen's worldwide assets at death no matter where they die. Furthermore, if you are a U.S. citizen resident in Canada you are also subject to Canadian income tax on your worldwide income during your lifetime and Canadian tax at death on registered assets and accrued capital gains on any non-registered assets. This article will discuss strategies that you should consider to minimize your global tax payable during your lifetime and minimize your global tax at death to maximize your estate.*

**Due to the complex tax rules for U.S. citizens residing in Canada, it is imperative that you obtain professional advice from a qualified advisor specializing in cross border tax and estate planning before acting upon any of the information in this article. Furthermore, although some of the rules and strategies in this article will also apply to green-card holders, if you are a green-card holder please consult with a qualified advisor before acting upon any of the information in this article.**

Due to the many different issues related to this topic, this article is fairly lengthy. However, for better readability, this article has been subdivided into the following five sections:

- A. Canadian and U.S. income tax filing requirements**
- B. Avoiding double taxation**
- C. Tax planning for U.S. citizens in Canada**
- D. U.S. citizens investing in Canada**
- E. Estate planning for U.S. citizens in Canada**

## A. Canadian and U.S. income tax filing requirements

Given you are a U.S. citizen residing in Canada, you will be required to file at least two individual income tax returns every year.

### Canadian income tax filing requirements

As a resident of Canada you will have to file a Canadian income tax return (T1) to the Canada Revenue Agency (CRA) reporting your **worldwide** income. If you reside in Quebec, you will also have to file a Quebec provincial income tax return (TP-1-V) to Revenu Quebec reporting your worldwide income.

**Filing deadline:** April 30<sup>th</sup> of the following year or June 15<sup>th</sup> of the following year if you or your spouse is self-employed. Regardless of the filing deadline, any balance of tax owing must be paid to the CRA (and Revenu Quebec if applicable) by April 30<sup>th</sup> of the following year to avoid late interest charges.

### U.S. income tax filing requirements

As a U.S. citizen, you will have to file a federal U.S. income tax return (Form 1040) to the Internal Revenue Service (IRS) reporting your **worldwide** income. This is the same income tax return that residents of the U.S. file every year. If you are married, both you and your spouse can file one joint federal U.S. income tax return reporting combined incomes. In many cases, filing a joint return is more beneficial than filing separate U.S. tax returns. Since you are likely not a resident of a particular U.S. state, you will not have to file a U.S. state income tax return unless you have specific income from that U.S. state.

**Filing deadline:** June 15<sup>th</sup> of the following year if you live outside the U.S. and your main place of employment is outside the U.S. Regardless of the filing deadline, any balance of tax owing must be paid to the IRS by April 15<sup>th</sup> of the following year to avoid late interest charges.

**If you are not filing annual U.S. income tax returns, speak to a qualified tax advisor about filing past U.S. tax returns.** The IRS will typically accept the filing of the last six year's U.S. income tax returns. In many cases, there will be little or no U.S. tax owing on your annual U.S. tax return due to foreign earned income exclusions and foreign tax credits (as discussed below). However not filing U.S. income tax return may create problems when you visit the U.S. or if your family is planning to apply for U.S. citizenship in the future.

## B. Avoiding double taxation

Since you are required to file at least two income tax returns reporting your worldwide income, there are measures in place to avoid or minimize paying tax on the same income to both the CRA and the IRS. In general, you will only pay tax at a rate that is the higher of Canada and the U.S. In most cases, the Canadian federal and provincial tax rates are higher than the U.S. federal tax rates. Unless otherwise stated in the Canada-U.S. Income Tax Treaty (the "Treaty"), the country where the income is earned or "sourced" is the country to which you would pay the taxes to related to that income.

### Canadian tax return

If you have income from U.S. sources that you are reporting on your Canadian tax return and you are paying U.S. taxes to the IRS on this same income, then you are eligible to claim a foreign tax credit on the Canadian tax return to avoid or minimize double taxation.

### U.S. tax return

If you have earned income (employment or self employment income) from services performed outside the U.S. and your regular place of employment is outside the U.S., you are eligible to exclude up to \$85,700 US of this foreign earned income on your U.S. income tax return. This exclusion is called the "foreign earned income exclusion". In addition to the foreign earned income exclusion, if you are a qualifying individual, you may elect to exclude from income, or in some cases deduct from income, a housing cost amount based on your housing expenses (i.e. rent, maintenance, insurance, utilities, repairs, etc.). The maximum housing costs that can be excluded (or deducted) from income for 2007 is generally \$11,998 however in certain high cost cities this amount can be considerably higher as prescribed by the IRS.

If after taking the foreign earned income exclusion you still have income from Canadian sources that you are reporting on your U.S. tax return and you are paying Canadian taxes to the CRA on this same income, then you are eligible to claim a foreign tax credit on the U.S. tax return to avoid or minimize double taxation.

After claiming the foreign earned income exclusion and taking foreign tax credits you may not have any U.S. taxes payable on your U.S. income tax return. Even though this is the case, you still have to file an annual U.S. income tax return unless your worldwide income is very low.

Note that claiming the foreign earned income exclusion is a choice. If you do not claim the foreign earned income exclusion then you will have to claim more foreign tax credits to reduce your U.S. tax. However, under new U.S. "stacking" tax rules, the foreign earned income exclusion is now a deduction starting from the lowest U.S. marginal tax rates compared to the previous rules where the deduction was at your higher marginal tax rates. As a result, in some cases you may be better off not claiming the foreign earned income exclusion but rather claiming more foreign tax credits. Speak to a qualified cross border tax specialist to determine which method is better for you.

## C. Tax planning for U.S. citizens in Canada

### RSPs

In general there are two main Canadian tax benefits of making RSP contributions – the contributions are tax-deductible for Canadian tax purposes and the income earned in the RSP grows on a tax-deferred basis until withdrawn.

RSP contributions cannot be deducted for U.S. tax purposes. However, the income earned in the RSP can be tax-deferred for U.S. tax purposes **but only if you complete IRS Form 8891 every year** with your annual U.S. 1040 income tax return.

Since Canadian income taxes are generally higher than U.S. income taxes, there is still a benefit for many U.S. citizens living in Canada to make RSP contributions.

### U.S. retirement plans

If you have assets in a qualified U.S. retirement plan (IRA, 401(k), etc) that you earned before moving up to Canada, then the income earned in these U.S. plans will continue to grow on a tax-deferred basis both for Canadian and U.S. tax purposes.

If you plan on retiring in Canada and want to consolidate these U.S. retirement plans with your Canadian RSP for ease of administration, then speak to your advisor. There is a strategy to contribute these U.S. retirement assets into a Canadian RSP on a tax-deferred basis regardless of the amount of your unused RSP deduction room.

### Excess foreign tax credits

Since Canadian tax rates are generally higher than U.S. federal income tax rates, you will likely be accumulating “excess” foreign tax credits on your U.S. income tax return. See Form 1116 of your last U.S. tax return to determine the amount of excess foreign tax credits you have accumulated, as there are strategies to utilize these excess foreign tax credits.

### **Example:**

Mary is a married U.S. citizen living in Canada and earns \$250,000 US (\$262,500 Cdn @ \$1.05 Cdn/US) per year. She has no other income and all her income is Canadian source. Her spouse has no income. The amounts in the following table are all in US\$.

|   | <b>Canadian tax return</b> | <b>U.S. tax return</b> |
|---|----------------------------|------------------------|
| Taxable income                                    | \$250,000                  | \$146,800 (a)          |
| Taxes payable before foreign tax credits          | \$100,000                  | \$41,650 (b)           |
| Final taxes payable                               | \$100,000                  | NIL (c)                |
| Excess foreign tax credits eligible for carryover | N/A                        | \$24,070 (d)           |

- (a) \$250,000 - \$85,700 foreign earned income exclusion – \$17,500 of standard and personal deductions
- (b) U.S. tax payable on remaining income based on marginal tax rates above \$85,700 under new IRC stacking rules. Married filing joint tax rates used.
- (c) U.S. taxes payable after claiming foreign tax credits of \$41,650 due to the taxes payable to Canada on same income
- (d) Unused foreign tax credit of \$58,350 [\$100,000 – \$41,650]. However, a portion of this unused foreign tax credit must be reduced by the amount of foreign taxes allocable to the foreign earned income exclusion, which is \$34,280 [\$85,700/\$250,000 x \$100,000]. So the amount of excess foreign tax credit eligible for carryover is \$24,070 [\$58,350 - \$34,280]. Speak to a qualified cross border tax specialist to determine whether it is better for you to claim the foreign earned income exclusion or claim more foreign tax credits in order to reduce your U.S. tax.

Excess foreign tax credits can be carried back one year or carried forward ten years for U.S. tax purposes. **Can these excess foreign tax credits be utilized before they expire in order to reduce your taxes?** Yes, it may be possible, so speak to a qualified cross border tax advisor for strategies.

One such strategy to utilize excess foreign tax credits is to have a Canadian employer make contributions to a Retirement Compensation Arrangement (RCA) while you are a Canadian resident. You would then make withdrawals from the RCA in retirement while a **non-resident** of Canada. This strategy reduces your global tax rate on compensation that may have been taxed at 39-49% down to about 15% or 25%. Speak to your advisor for a copy of the article titled "*Retirement Compensation Arrangement (RCA)*" if you are interested in learning more details about an RCA.

The basic mechanics of the strategy are as follows:

1. The RCA is structured so that contributions to the RCA and income earned in the RCA are non-taxable to the employee for Canadian tax purposes (although there is a 50% refundable tax that the **RCA trust** pays on contributions and income).
2. However, the RCA contributions and investment income earned in the RCA is included as taxable employment income to the employee on his/her U.S. income tax return since the US taxes employees on funded vested retirement arrangements. If the U.S. citizen employee has adequate excess foreign tax credits on the U.S. tax return from the current and/or previous years, there will generally be no U.S. tax payable to the employee on this income inclusion.
3. The U.S. citizen employee becomes a non-resident of the Canada and retires in the U.S.
4. The U.S. citizen then makes withdrawals from the RCA. There will be a 25% Canadian non-resident withholding tax on the RCA withdrawals, which may potentially be reduced to 15% if periodic withdrawals are made from the RCA.
5. Since the RCA income was already included on the U.S. income tax return when contributions were made, the withdrawal from the RCA is generally considered a return of capital and thus non-taxable for U.S. tax purposes.

As you can see, by utilizing excess foreign tax credits, compensation that may have originally been taxed of up to 49% in Canada, could ultimately be taxed at 15% or 25%. Note that in some cases the global tax rate could be further reduced if the Canadian non-resident withholding can be taken as an itemized deduction on the U.S. income tax return.

Please note that the above strategy is complex and requires your employer to set up an RCA. Furthermore, it is imperative that the above strategy takes into account the new U.S. non-qualified deferred compensation rules in section 409A of the Internal Revenue Code, which was introduced in the American Jobs Creation Act of 2004. Speak to a qualified cross border tax advisor to determine if you qualify for this strategy as well as other strategies to utilize your excess foreign tax credits.

#### U.S. beneficiaries of foreign trusts

If you, as a U.S. citizen, are or will be a beneficiary of a trust that is **not** resident in the U.S., then there are some potentially punitive U.S. tax rules ("throwback rules") when income is paid out of the trust to you.

Although the rules are complex, in general, income and capital gains that have been accumulated in a non-U.S. trust and then paid out to U.S. beneficiaries in a subsequent tax year are taxed at a higher U.S. tax rate than if the income and capital gains were paid out to the U.S. beneficiary in the same year it was earned.

If the throwback rules apply, then accumulated income paid out in a future year loses its character and is all taxed as ordinary income. Furthermore, an interest charge is applied on the tax owing since U.S. tax was not paid during the time the income was accumulating in the foreign trust.

There are strategies to avoid or minimize this higher U.S. tax on distributions from foreign trusts, such as paying income out of the trust in the year that it is earned, so speak to a qualified cross border tax advisor for details.

#### Renouncing U.S. citizenship

If you are considering renouncing your U.S. citizenship for various reasons including the avoidance of the administrative burden of filing U.S. income tax returns reporting your worldwide income, then you should be aware of the ramifications of doing so.

The U.S. has “expatriation tax” rules, which basically means that if you renounce your U.S. citizenship, you will continue to be subject to U.S. income tax on your U.S. source gross income for the 10 years following your renunciation. Your U.S. source gross income also includes gains on the sale of U.S. stock.

Note that the expatriation tax rules will only apply to you if at the time you lose your U.S. citizenship, your net worth is at least \$2,000,000 US **or** your average annual U.S. income tax payable for the five years prior to loss of citizenship was at least \$136,000 US. In certain cases, you can avoid the expatriation tax rules if you are also a citizen of another country and were never a U.S. resident.

If you spend at least 30 days in the U.S. during any calendar year in the ten years following loss of citizenship then you will be considered a U.S. citizen for that year and must file a U.S. income tax return reporting worldwide income.

If you are considering renouncing your U.S. citizenship you should also speak to a qualified U.S. immigration lawyer for any consequences to yourself and your family after loss of citizenship.

## D. U.S. citizens investing in Canada

Some important tax issues that a U.S. citizen investing in Canada should be aware of are as follows.

### Qualified Intermediary (QI)

A U.S. citizen investing through an investment account located in Canada must supply appropriate taxpayer identification information (e.g. IRS Form W-9) to RBC related to the U.S. Qualified Intermediary (QI) rules. If appropriate QI documentation were provided to RBC, then there would generally be no U.S. withholding tax on U.S. source income. However, the income must still be reported on both Canadian and U.S. income tax returns and appropriate tax paid.

### Passive Foreign Investment Company (PFIC)

There are harsh U.S. tax rules for U.S. citizens that invest in a Passive Foreign Investment Company (PFIC). A PFIC is basically a non-U.S. corporation where the majority of the income earned or assets owned by the corporation are passive (i.e. cash, bonds, stocks, etc). Most Canadian based mutual funds are considered PFICs for U.S. tax purposes since they primarily hold investments that are passive in nature and for U.S. tax purposes a Canadian based mutual fund is typically considered as a non-U.S. corporation.

The PFIC rules can be avoided for Canadian based mutual funds held in an RSP/RIF if IRS Form 8891 is completed on an annual basis.

Although the PFIC rules are complex, one punitive component of the PFIC rules relates to when the mutual fund is sold for a capital gain. In this case, the capital gain is prorated over your holding period and the capital gain attributed to prior years is all taxed as income at the top U.S. marginal tax rate for that year. So the lower capital gains tax rate (maximum 15% if held for more than one year) is lost for U.S. tax purposes. In addition, a late interest charge is applied for the prior year's U.S. tax that should have been paid. The capital gain attributed to the current year is also considered as income and taxed at regular marginal U.S. tax rates.

The PFIC rules can be avoided by investing in individual stocks or bonds. Alternatively, if you want mutual fund type investments you can invest in the iShares which are Exchange Traded Funds (ETFs) trading on the NYSE as these would not be considered as PFICs. Note that the iUnits trading on the TSX are structured as Canadian based mutual funds and therefore are likely considered PFICs. Speak to your advisor regarding the investment merits of individual stocks/bonds vs. mutual funds vs. ETFs.

Canadian based income trusts that carry on an active business may also escape the PFIC rules, however you should consult with a qualified tax advisor for confirmation.

There are other strategies to minimize the impact of the PFIC rules such as making a mark-to-market or Qualified Electing Fund (QEF) election. The details of these elections are beyond the scope of this article.

## E. Estate planning for U.S. citizens in Canada

For purposes of this section we will primarily discuss strategies to defer or minimize U.S. federal estate tax for U.S. citizens. In 2007, U.S. estate tax can be as high as 45% on the **fair market value** of assets at death, so it's clearly a punitive tax that needs to be planned for. Some U.S. states also have estate tax, however this article will only discuss planning for U.S. Federal estate tax.

There are **three** main rules to be aware of related to U.S. estate tax for U.S. citizens:

1. U.S. citizens are subject to U.S. estate tax on the fair market value of their worldwide assets at death (among other things this even includes a Canadian principal residence, RSP and even certain life insurance proceeds paid after death). This is clearly more punitive than Canadian residents that are not U.S. citizens, who are only subject to U.S. estate tax on U.S. situs assets.
2. For deaths occurring in 2007-2008, U.S. estate tax only applies on a U.S. citizen's worldwide estate in excess of \$2,000,000 US.
3. There is an unlimited deferral of U.S. estate tax if assets pass to a surviving U.S. citizen spouse.

For purposes of this discussion we will provide estate and cross border Will planning strategies under the following four scenarios:

- a) Both spouses are U.S. citizens
- b) Only one spouse is a U.S. citizen and assume the U.S. citizen spouse dies first
- c) Only one spouse is a U.S. citizen and assume the non-U.S. citizen spouse dies first
- d) At least one spouse is a wealthy U.S. citizen and he/she has a U.S. citizen child

a) Both spouses are U.S. citizens

For 2007, each spouse is permitted to exempt the first \$2,000,000 US of assets from U.S. estate tax. However, since there is an unlimited amount of U.S. estate taxes that can be deferred until the death of the second U.S. citizen spouse to die, then the \$2,000,000 US exemption of the spouse that died first was never used. In order to alleviate this dilemma, it is recommended that high net worth U.S. citizen couples set up a “credit shelter trust” in each of their Wills (also known as a bypass trust or A/B trust). A credit shelter trust is normally a testamentary trust where an amount up to the U.S. estate tax exemption in the year of death (\$2,000,000 US for deaths in 2007-2008) flows into the trust. Since the amount contributed to the credit shelter trust is under the U.S. estate tax exemption, there is no U.S. estate tax on the death of the first spouse related to these assets. **Furthermore, there would be no U.S. estate tax on the trust assets on the death of the second spouse regardless of how much the trust assets appreciated after the death of the first spouse.**

A spouse and/or children can be beneficiaries of the credit shelter trust. The beneficiaries have full access to the income of the trust but additional amounts from the trust are typically limited for health, education, support and maintenance of the beneficiaries.

Any remaining assets of the spouse that died first in excess of the amount flowing into the credit shelter trust can then pass directly to the surviving spouse or to a properly structured marital deduction spousal trust to be eligible for the unlimited marital deduction.

Consider the following example that demonstrates the substantial tax savings that can be realized by having a credit shelter trust provision in the Will of a U.S. citizen.

**Example:** John is married to Jennifer. Both are U.S. citizens. John dies in 2007 and his estate is worth \$3,000,000 US at that time and all his assets pass to Jennifer. Jennifer dies in 2008 and her estate at death is worth \$5,000,000 US (includes \$3 million received from John’s estate)

|  | No credit shelter trust | Credit shelter trust |
|--|-------------------------|----------------------|
| Value of assets on death of first spouse                               | \$3,000,000 US          | \$3,000,000 US *     |
| U.S. estate tax on death of first spouse (unlimited marital deduction) | NIL                     | NIL                  |
| Value of assets on death of second spouse                              | \$5,000,000 US          | \$5,000,000 US **    |
| <b>U.S. estate tax on death of second spouse</b>                       | <b>\$1,350,000 US</b>   | <b>\$450,000 US</b>  |

\* \$2,000,000 US flows to credit shelter trust and \$1,000,000 US flows directly to surviving U.S. citizen spouse

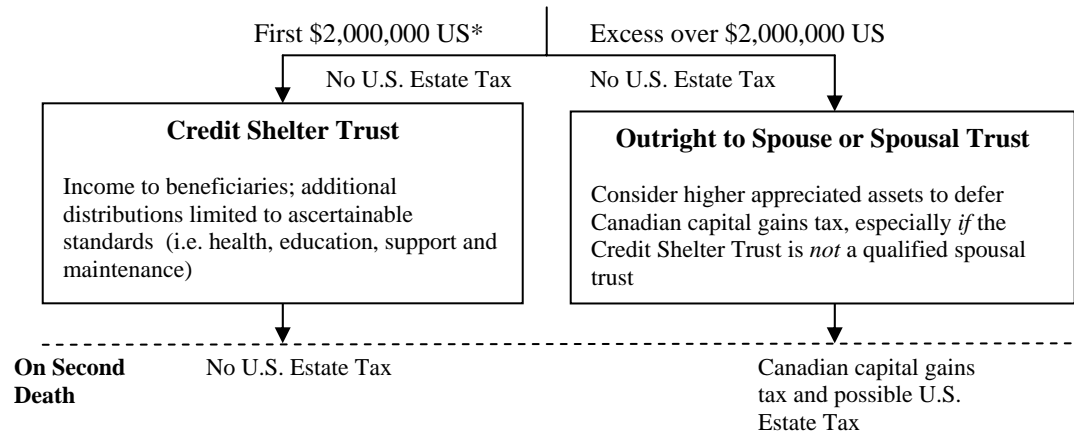
\*\* Comprised of \$2,000,000 US in credit shelter trust and \$3,000,000 US held personally. Only the assets held personally are subject to U.S. estate tax.

As you can see, Jennifer’s estate saves **\$900,000 US** [\$1,350,000 – \$450,000] of U.S. estate taxes by having the first \$2,000,000 US of John’s estate flow into a credit shelter trust upon his death. The savings can be much larger if the assets in the credit shelter trust appreciated after the death of the first spouse, since even the appreciation within the credit shelter trust avoids U.S. estate tax.

**Since in most cases, the credit shelter trust is a testamentary trust, it is imperative that the assets that intend on flowing to the credit shelter trust not be held in JTWROS** (not applicable in Quebec). Assets held in JTWROS cannot fund a credit shelter trust on the death of the first spouse since these assets will not form part of the estate of the spouse that died first but rather pass directly to the surviving spouse.

The following is a diagram that demonstrates a typical estate plan and flow of assets after death where both spouses are high net worth U.S. citizens:

### On First Death



\* \$2,000,000 US is the U.S. estate tax exemption for deaths in 2007-2008. This exemption will be \$3,500,000 US in 2009 and there is an unlimited exemption in 2010 (i.e. no U.S. estate tax at all). However, unless there are legislative changes, the U.S. estate tax exemption is slated to drop to \$1,000,000 US for deaths after 2010.

### Lifetime gifts

Another strategy to minimize your U.S. estate tax is by making lifetime gifts of your **surplus assets** in order to reduce the taxable estate at death subject to U.S. estate tax. However, be careful with this strategy since the fair market value of gifts made by U.S. citizen donors are subject to a U.S. gift tax (at similar graduated tax rates as U.S. estate tax), unless specifically excluded. Gifts of any amount can be made to a U.S. citizen spouse with no gift tax.

Furthermore, there is no gift tax for gifts up to \$12,000 US per year to any beneficiary. If both U.S. citizen spouses consent, then a couple can split the gift and make a gift of up to \$24,000 US per year to any beneficiary with no gift tax.

If a gift exceeded the \$12,000 US or \$24,000 US annual exclusion then the excess gift may also be exempt from gift tax since there is a lifetime gift tax exemption of \$1,000,000 US. However, using part of this lifetime gift tax exemption then reduces your U.S. estate tax exemption (\$2,000,000 US for 2007) available at death dollar for dollar. Gifts that are under the annual exclusion (\$12,000 or \$24,000) do not reduce the lifetime gift or estate tax exemption.

Among other things, gift tax is not applicable when gifts are made to charities. Additionally, amounts paid directly to an education organization for tuition expenses, or payments made to health care providers for medical services on behalf of a donee are not considered taxable gifts.

b) Only one spouse is a U.S. citizen and assume the U.S. citizen spouse dies first

In the case where only one spouse is a U.S. citizen then the Will planning and structures are slightly different. As previously mentioned, the U.S. citizen spouse is subject to U.S. estate tax on worldwide assets in excess of \$2,000,000 US, however the non-U.S. citizen spouse is only subject to U.S. estate tax on U.S. situs assets (e.g. US real estate, US stock, etc).

As a result, if the U.S. citizen spouse has more than \$2,000,000 US of assets in their name, then from a planning perspective it makes sense for the U.S. citizen spouse to gift non-U.S. situs assets to the non-U.S. citizen spouse during their lifetime to “rebalance” assets. The U.S. tax rules allow a U.S. citizen to gift up to \$125,000 US per year to a non-U.S. citizen spouse without being subject to U.S. gift tax. There is no Canadian capital gains tax on rebalancing of assets between spouses however the income attribution rules will apply.

It can also make sense for the U.S. citizen spouse to make gifts up to the annual gift tax exclusion of \$12,000 US per year to other family members. However, a U.S. citizen spouse and a non-U.S. citizen spouse cannot consent to split their gifts up to \$24,000 US per year to one donee. The strategy of gift splitting only applies where both spouses are either U.S. citizens or residents.

Although it is not always used or strongly recommended, it still may make sense to have a credit shelter trust provision in the U.S. citizen spouse’s Will in order to ensure that the first \$2,000,000 of assets of the U.S. citizen at death and any future growth are never subject to U.S. estate tax. The reasons that such a credit shelter trust may be beneficial to the surviving non-U.S. citizen spouse include: potentially sheltering U.S. situs assets from U.S. estate tax; or minimizing U.S. estate tax for the surviving non-U.S. citizen spouse in the event that he/she later chooses to become a U.S. citizen (or U.S. resident). If the U.S. citizen spouse is expected to have more than \$2,000,000 US of assets in their name at death, then there is no unlimited deferral of U.S. estate taxes on the assets in excess of \$2,000,000 since the surviving spouse is not a U.S. citizen.

However, there are two estate planning techniques to minimize or defer the U.S. estate tax on the death of a high net worth U.S. citizen spouse who has assets in excess of \$2,000,000 US and where the assets are flowing to a non-U.S. citizen surviving spouse.

- i) Marital credit under the Canada-U.S. Tax Treaty; or
- ii) Qualified Domestic Trust (QDOT)

Note that if the marital credit is taken, then the QDOT strategy cannot be used.

*Marital credit under the Treaty*

If certain conditions are met then a marital credit is allowed against U.S. estate tax for property passing to a surviving spouse or a spousal trust. The amount of the marital credit cannot exceed the amount of the credit against U.S. estate tax that the U.S. citizen spouse received on their death. The maximum credit that the U.S. citizen spouse can receive on their death against U.S. estate tax is \$780,800 US (this tax credit equates to worldwide assets of \$2,000,000 US). Therefore, under the Treaty, another \$780,800 US of credit can be taken against U.S. estate tax for those assets passing to the surviving spouse. Due to the progressive U.S. estate tax rates, an additional U.S. estate tax credit of \$780,800 US equates to another \$1,700,000 US of assets that can flow to the surviving non-U.S. citizen spouse with no U.S. estate tax. So if the marital credit is taken, then up to \$3,700,000 US of assets can flow to the deceased’s U.S. citizen beneficiaries with no U.S. estate tax payable (i.e. first \$2,000,000 US to the credit shelter trust and another \$1,700,000 US directly to the spouse or spousal trust).

*Qualified Domestic Trust (QDOT)*

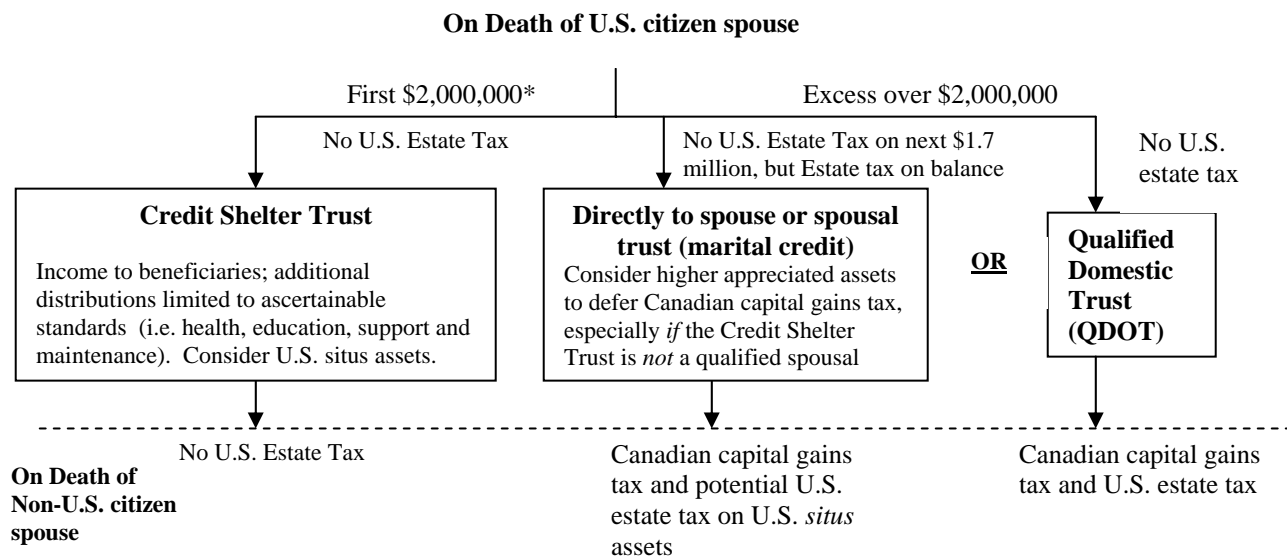
Instead of taking the marital credit, it is possible to defer an unlimited amount of U.S. estate tax on the death of the first spouse if the deceased assets flow into a Qualified Domestic Trust (QDOT).

A QDOT is a trust where the non-U.S. citizen surviving spouse is the beneficiary. In this case, the U.S. estate tax can be deferred for assets flowing into a QDOT. The deferral lasts until capital is distributed from the QDOT to the non-U.S. citizen surviving spouse and/or until the death of the

surviving spouse at which time the U.S. estate tax is payable. Note that when the U.S. estate tax is payable related to assets distributed from the QDOT, the tax rates used are the U.S. estate tax rates that were applicable in the year that the U.S. citizen spouse died. So the QDOT does not avoid or minimize U.S. estate tax, it simply defers it.

There are a number of criteria in order for a trust to qualify as a QDOT; such as at least one trustee must be a U.S. citizen or U.S. corporation. If the assets in the QDOT have a value of at least \$2 million at the decedent's death (or the alternate valuation date if applicable), additional requirements are necessary. Under a large QDOT, at least one trustee must be a US bank or a bond or letter of credit must be provided in favor of the IRS. Although the QDOT helps to defer U.S. estate tax, it can also be structured to defer Canadian capital gains tax for appreciated assets passing to a spousal trust.

The following is a diagram that demonstrates a typical estate plan and flow of assets after death where only spouse is a U.S. citizen and the U.S. citizen spouse dies first:



\* \$2,000,000 US is the U.S. estate tax exemption for deaths in 2007-2008. This exemption will be \$3,500,000 US in 2009 and there is an unlimited exemption in 2010 (i.e. no U.S. estate tax at all). However, unless there are legislative changes, the U.S. estate tax exemption is slated to drop to \$1,000,000 US for deaths after 2010.

As previously noted, if the marital credit is taken then the QDOT strategy cannot be used. Therefore, the executor must make a decision on which strategy is more beneficial for a particular couple. In general, if the U.S. citizen spouse dies first and his/her estate is less than \$3,700,000 US, then the marital credit is normally taken to avoid U.S. estate tax altogether. However, if the estate of the U.S. citizen spouse is expected to be greater than \$3,700,000 US then a cost/benefit analysis needs to be undertaken by the executor on which strategy is more beneficial.

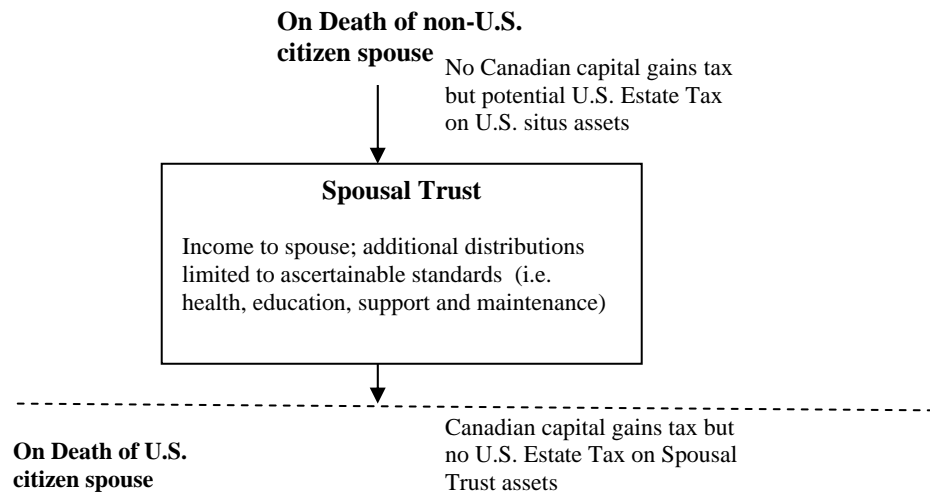
The key is that the Will of the U.S. citizen spouse should be drafted in such a way that either option would be eligible for the executor (i.e. marital credit or QDOT).

c) Only one spouse is a U.S. citizen and assume the non-U.S. citizen spouse dies first

In the case where only one spouse is a U.S. citizen but the non-U.S. citizen spouse dies first, then the estate planning structure would be different than previously discussed.

If the couple's worldwide assets are expected to be greater than \$2,000,000 US, then it is imperative that assets of the first to die spouse do not form part of the worldwide estate of the surviving U.S. citizen spouse. As a result, the typical planning in this case is for the assets of the non-U.S. citizen spouse that dies first to flow into a spousal trust of which the surviving U.S. citizen spouse is the beneficiary. The income earned in the spousal trust can be payable to the surviving spouse however distributions of capital would be limited to health, education, support and maintenance. Given the surviving spouse does not have free access to the capital in the spousal trust, upon the death of the U.S. citizen spouse, the spousal trust assets would not form part of their estate for U.S. estate tax purposes.

The following is a diagram that demonstrates a typical estate plan and flow of assets after death where only one spouse is a U.S. citizen and the non-U.S. citizen spouse dies first:

*Lifetime gifts*

The previous discussion on lifetime gifts also applies in this case. That is, the U.S. citizen spouse should try to make gifts of up to \$125,000 US per year to the non-U.S. citizen spouse and/or gifts of up to \$12,000 per year to other beneficiaries. This way more assets can accumulate in the name of the non-U.S. citizen spouse that can eventually fund a spousal trust if the non-U.S. citizen spouse were to die first. If set up correctly, the assets in the spousal trust would then be exempt from U.S. estate tax on the death of the U.S. citizen spouse.

d) At least one spouse is a wealthy U.S. citizen and he/she has a U.S. citizen child

In addition to planning to reduce each other's exposure to U.S. estate tax, another planning objective for married spouses, where at least one is a wealthy U.S. citizen, may be to reduce their U.S. citizen child's exposure to U.S. estate tax.

*Generation Skipping Transfer Tax (GSTT)*

In addition to the gift tax, the U.S. imposes a **second** tax when gifts are made by a U.S. citizen to those family members that are two or more generations below the donor (i.e. typically gifts made to grandchildren). This tax is called the Generation Skipping Transfer Tax (GSTT). The GSTT is a flat tax on the value of the gift equal to the top U.S. estate tax rate (45% for 2007), so this tax is very punitive.

There is a GSTT because if a grandparent, either while alive or at death, gifts property directly to their grandchild they would avoid one layer of gift tax compared to those grandparents that gift property to a child (rather than a grandchild) and then the child in turn gifts the property to their own child (the grandchild). In this two-transfer situation, two gift taxes would be imposed; consequently, the GSTT adds a second tax to gifts you make directly to your grandchildren.

However, gifts that are eligible for the \$12,000 US annual gift tax exclusion will also be exempt from the GSTT. In addition, there is a lifetime GSTT exemption of \$2,000,000 US for 2007 that can be used to avoid the GSTT for gifts above the annual exclusion. Given that the GSTT is an **additional** layer of tax, the lifetime GSTT exemption is **in addition** to the lifetime U.S. gift and Estate Tax exemption.

So this means that a wealthy U.S. citizen couple with 3 children and 5 grandchildren could make gifts of \$192,000 US **per year** [ $\$24,000 \times 8$ ] if they consent to split the gifts. This allows them to avoid gift tax and GSTT and now their taxable estate would be lower to help minimize U.S. estate tax.

There is no gift tax or GSTT applicable to Canadians (i.e., non-U.S. citizens). However gifting assets to non-spouses will trigger a capital gain/loss to the donor for Canadian tax purposes.

For GSTT planning, trusts (sometimes referred to as *Dynasty Trusts*, which are explained in further detail on the next page in the context of life insurance) are often used, and the maximum amount that can be transferred into such a trust, without triggering unwanted GSTT or US estate tax, is the US estate tax /GSTT exemption amount of \$2,000,000 US for 2007. However, this "\$2,000,000 US" exemption only applies if the (GSTT) trust is funded at death; if the trust is set up and funded while the donor is alive (which is what will always occur in the context of *Dynasty Trusts* where life insurance is used), the maximum amount that can be funded into the trust to avoid gift tax, GSTT and future estate tax is \$1,000,000 US, i.e., the donor's lifetime U.S. gift tax exemption. For a non-U.S. citizen spouse, properly structured trusts can also be used to reduce his/her U.S. citizen child's exposure to U.S. estate tax, however there is no limit regarding the amount of money that can be transferred into such a trust.

If only one spouse is a U.S. citizen, as previously discussed, a common U.S. estate tax minimization strategy consists of the U.S. citizen spouse gifting as many assets as possible (annual gift tax exclusion of \$125,000 US) to the non-U.S. citizen spouse prior to death. Upon the demise of the non-U.S. citizen spouse, he/she will ensure that such assets are transferred into a testamentary trust (that has no limit on the amount that can be funded into it) in favour of the U.S. citizen children/grandchildren. Therefore, GSTT planning is often not necessary when at least one spouse is a non-U.S. citizen, and consequently it is most prevalent where *both* spouses are very wealthy U.S. citizens.

Irrevocable Life Insurance Trust (ILIT)

An estate planning strategy for high net worth U.S. citizens is to purchase insurance to help the estate pay for any U.S. estate tax. Ironically though, if the U.S. citizen has too much control over the insurance policy then the insurance proceeds would form part of the U.S. citizen's estate and potentially subject to U.S. estate tax. This is quite punitive, since life insurance proceeds are tax-

free for Canadian tax purposes but if not structured properly for a U.S. citizen then up to 45% of the proceeds may be paid in U.S. estate tax.

In order to alleviate this dilemma, many high net worth U.S. citizens will have an irrevocable life insurance trust (ILIT) own the insurance policy instead of them owning it directly. Life insurance proceeds paid to a properly structured ILIT do not form part of the U.S. citizen's estate and thus there would be no U.S. estate tax for either the estate or the beneficiaries of the ILIT.

Therefore, if you are currently the owner of a life insurance policy or are considering purchasing a life insurance policy, then you should speak to your tax advisor on whether the policy should be owned by an ILIT.

The downside of the ILIT for U.S. citizens living in Canada is that the ILIT is considered an inter vivos trust and therefore the income splitting benefits of a Canadian testamentary insurance trust will not be available.

If you require more details on the ILIT, then speak to your advisor for a copy of the article titled "*U.S. Estate Tax Planning Using Life Insurance*".

#### *Dynasty Trusts*

If you want to take your ILIT to the next level and provide inheritances to not only your spouse and children, but also grandchildren and perhaps even your great-grandchildren with no U.S. gift tax, Estate tax, or GSTT, the Dynasty Trust (mentioned briefly on the previous page) may be the solution. The Dynasty Trust is simply a fancy term for a trust that takes advantage of or leverages your lifetime gift/Estate and/or GSTT exemptions and can result in tax-free inheritances to successive generations.

For example, assume you make a large one-time cash payment to a properly structured ILIT. The cash is used to make a single premium payment on a significant face value life insurance policy purchased by the ILIT. The beneficiaries of the ILIT include your spouse, your children and your grandchildren. The cash transfer to the ILIT is considered a gift. However, as long as it is under your lifetime \$1,000,000 US gift tax exemption, there will be no U.S. gift taxes and no GSTT on the transfer (since it's also under the lifetime GSTT exemption).

The payment of the life insurance proceeds, regardless of the amount, into the ILIT upon your death will avoid U.S. Estate Taxes to your estate. Furthermore, if structured properly, the fair market value of the trust assets upon the deaths of your spouse, your children and even your grandchildren will not form part of their estates regardless of the value and thus avoid U.S. Estate tax on their deaths as well.

For the Dynasty Trust to be effective - such that the assets within the trust do not form part of any family member's estate (i.e. both spouses, children, grandchildren, etc) - it is imperative that the Dynasty Trust be structured properly by a qualified estates lawyer with expertise in this area.

### Summary

Clearly, there are a number of additional tax and estate issues that a U.S. citizen in Canada needs to be aware of compared to a U.S. citizen living in the U.S. or a non-U.S. citizen living in Canada. In summary, the main issues to be aware of are:

1. Ensure you are up to date in your annual Canadian and U.S. income tax filing obligations (also file IRS Form 8891 on an annual basis if you have an RSP/RIF).
2. Be aware of the U.S. tax risks of owning Canadian based mutual funds in a non-registered account.
3. For high net worth U.S. citizens, consider gifts during your lifetime of surplus assets up to the annual gift exclusion amounts in order to reduce your taxable estate.
4. For high net worth U.S. citizens, ensure your Wills are properly drafted to maximize U.S. estate tax exemptions of both spouses (i.e. credit shelter trust).
5. Do not hold assets in JTWRROS (not applicable in Quebec) if you have credit shelter and spousal testamentary trust provisions in your Wills.
6. For high net worth U.S. citizens, consider having an ILIT own your life insurance policies rather than owned directly by you.

You should speak to a qualified cross border tax and estate advisor to determine if any of the planning ideas and strategies discussed in this article should be implemented for you.

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**Note: The above information is based on the current and proposed tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as offering tax or legal advice. Individuals should consult with qualified tax and/or legal advisors before taking any action based upon the information contained in this article.**

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