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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 U.S. citizens' worldwide assets at death no matter where they die. If you are a U.S. citizen who is 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 discusses strategies you should consider to minimize your global tax payable during your lifetime and 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. Further, although some of the rules and strategies in this article also apply to green-card holders, we have not specifically addressed green-card-holder issues, so if you are a green-card holder, please consult with a qualified advisor before acting on any of the information in this article.

Due to the many different issues related to this topic, this article is fairly lengthy. However, to make it easier to read, we have divided it 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

If 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 Revenue Quebec reporting your worldwide income.

Filing deadline: The deadline to file your Canadian income tax return is April 30 of the following year (or June 15 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 Revenue Quebec if applicable) by April 30 of the following year to avoid late interest charges.

U.S. INCOME TAX FILING REQUIREMENTS

As a U.S. citizen resident in Canada, 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 and your spouse are both U.S. citizens, 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. Unless you maintain your domicile in certain states that tax based on domicile and /or you have specific income from that U.S. state, you may not have to file a U.S. state income tax return.

Filing deadline: The deadline to file your U.S. income tax return is June 15 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 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 (discussed later). However not filing your 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 income tax returns reporting your worldwide income in both Canada and the U.S., there are measures in place to avoid or minimize the tax you have to pay to both the CRA and the IRS on the same income (i.e. double taxation). In general, you will pay tax at the higher of the Canadian and U.S. tax rates. 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 should pay the taxes 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 $91,400 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, or in some cases deduct, from your income a housing-cost amount based on your housing expenses (e.g. rent, maintenance, insurance, utilities, repairs). The maximum housing costs that can be excluded (or deducted) from income for 2009 are generally $12,796; however, in certain high-cost cities, this amount may 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 will 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 a deduction that starts at the lowest U.S. marginal tax rates as opposed to your higher marginal tax rates, which was the case under the previous rules. As a result, in some cases, you may be better off not claiming the foreign-earned income exclusion and instead 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 to 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 elect to defer the income and 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 to making RSP contributions for many U.S. citizens living in Canada.

U.S. RETIREMENT PLANS

If you have assets in a qualified U.S. retirement plan (IRA, 401(k), etc.) that you earned before moving to Canada, then the income earned in this U.S. plan 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 your U.S. retirement plans with your Canadian RSP for ease of administration, then speak to your advisor. There is a strategy for contributing these U.S. retirement assets to 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 accumulate "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 for utilizing these excess foreign tax credits.

Example: Mary is a married U.S. citizen living in Canada and earning $250,000 US ($302,500 Cdn at $1.21 Cdn/US exchange rate) per year. She has no other income and all her income is from a Canadian source. Her spouse has no income.

The amounts in the following table are all in US$.

	Canadian tax return	**U.S. tax return**
Taxable income	$250,000	$139,900 (a)
Taxes payable before foreign tax credits	$100,000	$38,925 (b)
Final taxes payable	$100,000	NIL (c)
Excess foreign tax credits eligible for carryover	N/A	$24,515 (d)

a. $250,000 – $91,400 foreign-earned income exclusion — $18,700 of standard and personal deductions.

b. U.S. tax payable on remaining income based on marginal tax rates above $91,400 under new IRC stacking rules. Married filing joint tax rates used.

c. U.S. taxes payable after claiming foreign tax credits of $38,925 due to the taxes payable to the CRA on the same income.

d. Unused foreign tax credit of $61,075 ($100,000 – $38,925). However, a portion of this unused foreign tax credit must be reduced by the amount of foreign taxes allocated to the foreign-earned income exclusion, which is $36,560 ($91,400 ÷ $250,000 x $100,000). So the amount of excess foreign tax credit eligible for carryover is $24,515 ($61,075 – $36,560).

Speak to a qualified cross-border tax specialist to determine whether it is better for you to claim the foreign-earned income exclusion or 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 10 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.

If you are planning to eventually return to the U.S., 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 can then make withdrawals from the RCA in retirement while a non-resident of Canada. This strategy will reduce your global tax rate on compensation — which could be as high as 39% to 49% — to about 15% or 25%. Speak to your advisor for a copy of the article “Retirement Compensation Arrangement (RCA)” if you are interested in learning more about an RCA.

The basic mechanics of this 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 the investment income earned in the RCA are included as taxable employment income to the employee on his/her U.S. income tax return since the U.S. taxes employees on funded vested retirement arrangements. If the U.S. citizen employee has adequate excess foreign tax credits on his/her U.S. tax return from the current and/or previous years, there is generally no U.S. tax payable by the employee on this income inclusion.

3. The U.S. citizen employee becomes a non-resident of Canada and retires in the U.S.

4. The U.S. citizen then makes withdrawals from the RCA. There is a 25% Canadian non-resident withholding tax on RCA withdrawals, which may be reduced to 15% if periodic withdrawals are made from the RCA.

5. Since the RCA income was already included on the U.S. citizen employee's U.S. income tax return when the 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 at 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 tax can be claimed as an itemized deduction on the U.S. income tax return.

Please note that this is complex and requires your employer to set up an RCA. Furthermore, it is imperative that this strategy take into account the U.S. non-qualified deferred compensation rules in section 409A of the Internal Revenue Code, which were 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 for utilizing your excess foreign tax credits.

TAX-FREE SAVINGS ACCOUNT (TFSA)

Although the investment income earned in a TFSA is tax-free for Canadian tax purposes, it is taxable on the U.S. citizen's U.S. tax return. However, it still may be beneficial for you to contribute to a TFSA because if you have adequate excess foreign tax credits on your U.S. tax return (related to passive income), you may be able to offset the U.S. tax on investment income earned in the TFSA. Speak to a qualified cross-border tax advisor to determine if you will have adequate excess foreign tax credits on your U.S. tax return to reduce or eliminate the U.S. tax on TFSA earnings.

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") for the income that is paid out of the trust to you.

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

If the throwback rules apply, then accumulated income paid out in a future year loses its character and is taxed as ordinary income. Furthermore, an interest charge is applied to 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, making distributions to non-U.S. trust beneficiaries and, in certain circumstances, structuring the trust in a manner that reduces the adverse tax implications for U.S. beneficiaries. Speak to a qualified cross-border tax advisor for details.

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 (i.e. fill out IRS Form W-9) to RBC® to satisfy the U.S. Qualified Intermediary (QI) rules. If appropriate, QI documentation is provided, and there is generally 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 the appropriate tax must be paid.

PASSIVE FOREIGN INVESTMENT COMPANY (PFIC)

There are harsh U.S. tax rules for U.S. citizens that invest in what is referred to as 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 (e.g. 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 to be 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 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 iShares, which are exchange-traded funds (ETFs) trading on the NYSE as they are generally not considered PFICs (although you should check to ensure that the ETF is set up as a U.S. domestic entity). 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 and 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 (not available for a private Canadian holding company that is a PFIC) or a Qualified Electing Fund (QEF) election. The details of these elections are beyond the scope of this article, so speak to a qualified cross-border tax advisor for additional details.

Note that U.S. citizens in Canada that own shares of a private Canadian active corporation or Canadian passive holding company are also potentially subject to the PFIC rules or the Controlled Foreign Corporation (CFC) rules. A discussion on the U.S. tax impact of these rules is beyond the scope of this article, so speak to a qualified cross-border tax advisor for additional details and U.S. tax reporting requirements.

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

For the purposes of this section, we will primarily discuss strategies to defer or minimize U.S. federal estate tax for U.S. citizens. For 2009, U.S. estate tax could be as high as 45% on the fair market value of assets at death. This is clearly a punitive tax that needs to be planned for. Some U.S. states also have estate tax; however, this article will discuss planning for U.S. federal estate tax only.

It is important to note that U.S. citizens that gift assets prior to death are liable for a gift tax (at rates similar to U.S. estate tax rates), which ensures that estate tax cannot be avoided by gifting assets during your lifetime.

There are **four** main rules to be aware of related to U.S. gift and 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 includes a Canadian principal residence, RSP and even certain life insurance proceeds paid after death). This is clearly more onerous than it is for Canadian residents who are not U.S. citizens and are subject to U.S. estate tax on U.S. situs assets only.

2. For deaths occurring in 2009, U.S. estate tax applies to a U.S. citizen's worldwide estate **in excess of $3.5 million US** only.

3. There is an unlimited deferral of U.S. estate tax if assets pass to a surviving U.S. citizen spouse, and U.S. citizen spouses can make unlimited lifetime gifts to each other free of U.S. gift tax.

4. Every U.S. citizen is entitled to a cumulative lifetime gift tax exemption of $1 million US, and is permitted to make annual gifts to any person of $13,000 US free of gift tax. This annual gift does not affect the $1 million US exemption.

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

A) Both spouses are U.S. citizens
B) Only one spouse is a U.S. citizen and the U.S. citizen spouse dies first
C) Only one spouse is a U.S. citizen and 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 2009, each spouse is eligible for an exemption on the first $3.5 million US in assets from U.S. estate tax. However, since there is an unlimited amount of U.S. estate tax that can be deferred until the death of the second U.S. citizen spouse; unless some action is taken, the $3.5 million US exemption of the spouse that died first may never be used. In order to address this issue, many U.S. tax practitioners recommend that high net worth U.S. citizen couples set up what is referred to as 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 ($3.5 million US for deaths in 2009) flows into the trust. Since the amount contributed to the Credit Shelter Trust is not greater than 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 is 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 a Credit Shelter Trust. The beneficiaries could 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 that exceed 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 2009. His estate is worth $4.5 million US at the time of death, and all his assets pass to Jennifer. Jennifer dies in 2010 and her estate at death is worth $7.5 million US (including the $4.5 million received from John's estate). For the purposes of this example, it is assumed that the U.S. estate tax exemption in 2010 is $3.5 million. Although the current U.S. law states that there will be no U.S. estate tax in 2010, regardless of the size of the estate, there is speculation that the current U.S. government will change this unlimited exemption rule prior to 2010.

(In U.S. dollars)

	No Credit Shelter Trust	**Credit Shelter Trust**
Value of assets on death of first spouse	$4.5 million	$4.5 million*
U.S. estate tax on death of first spouse (unlimited marital deduction)	NIL	NIL
Value of assets on death of second spouse	$7.5 million	$7.5 million**
U.S. estate tax on death of second spouse	**$1.8 million**	**$225,000**

* $3.5 million US flows to Credit Shelter Trust and $1 million US flows directly to surviving U.S. citizen spouse.
** Comprises $3.5 million US in Credit Shelter Trust and $4 million US held personally. Only the assets held personally are subject to U.S. estate tax.

As you can see, Jennifer's estate saves **$1,575,000** US ($1,800,000 – $225,000) in U.S. estate tax by having the first $3.5 million 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 appreciate 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 you intend on flowing into 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 they do not form part of the estate of the spouse that died first, but rather pass directly to the surviving spouse.

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

On first death

First $3.5 million US*

No U.S. estate tax

Credit Shelter Trust

Income to beneficiaries; additional distributions limited to ascertainable standards (e.g. health, education, support and maintenance)

Excess over $3.5 million US

Outright to spouse or spousal trust

Consider higher appreciated assets to defer Canadian capital gains tax if the Credit Shelter Trust is not a qualified spousal

On second death

No U.S. estate tax

Canadian capital gains tax and possible U.S. estate tax

* $3.5 million US is the U.S. estate tax exemption for deaths in 2009. 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 million US for deaths after 2010.

LIFETIME GIFTS

Another strategy to minimize your U.S. estate tax is to make lifetime gifts of your surplus assets in order to reduce your taxable estate at death subject to U.S. estate tax. However as noted earlier, those using this strategy must be mindful that the fair market value of gifts made by U.S. citizen donors is subject to U.S. gift tax, unless specifically excluded.

As we already pointed out, 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 $13,000 US per year to any beneficiary. If both U.S. citizen spouses agree, then a couple can split the gift and make a joint gift of up to $26,000 US per year to any beneficiary with no gift tax.

If a gift exceeds the $13,000 US or $26,000 US annual exclusion, then the excess gift may also be exempt from gift tax if use is made of the lifetime gift tax exemption of $1 million US. However, using part (or all) of this lifetime gift tax exemption reduces your U.S. estate tax exemption ($3.5 million US for 2009) available at death dollar for dollar. Gifts that are under the annual exclusion ($13,000 or $26,000) do not reduce either 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 educational organization for tuition expenses, or payments made to health care providers for medical services on behalf of a donee, are not considered taxable gifts.

DYNASTY TRUSTS

If you have **sufficient surplus** assets, you may want to use lifetime gift planning strategies to an even greater advantage. If you have not yet used your lifetime gift tax exemption of $1 million, or have only used part of it, then you can gift the maximum amount available to you under this exemption to a properly structured irrevocable trust for the benefit of family members, typically referred to as a "Dynasty Trust." These assets can then grow in the Dynasty Trust, just like assets in a Credit Shelter Trust, and never be subject to U.S. estate tax. While this strategy does not avoid annual income tax on income earned by the trust assets, the assets will not fall into the settlor's taxable U.S. **estate or the estate of any trust beneficiary, so long as the assets remain within the trust.**

While the amount gifted to a Dynasty Trust will reduce the amount available under your U.S. estate tax exemption, you are almost certainly going to be in a better position as you have started the process of growing the Dynasty Trust assets on an estate tax-free basis, in many cases years before this would have started had you waited and only used a Credit Shelter Trust strategy.

If you pursue this strategy, then upon your death, the remaining amount available under your U.S. estate tax exemption, which under 2009 rules would be $2.5 million US ($3.5 million U.S. estate tax exemption less $1 million U.S. gift to Dynasty Trust), would normally be transferred to the existing Dynasty Trust, rather than a separate Credit Shelter Trust, unless circumstances dictated otherwise.

There are ways to leverage the Dynasty Trust gift and estate tax strategy even further with the use of life insurance, which will be discussed later in this article.

Another advantage of using a Dynasty Trust is that the assets held in the trust are no longer owned by you personally, thereby providing an asset preservation strategy, as well as a probate and estate administration planning strategy, in relation to these specific assets. The benefits of these strategies will not be realized if you continue to own these assets in your own name.

B) ONLY ONE SPOUSE IS A U.S. CITIZEN AND THE U.S. CITIZEN SPOUSE DIES FIRST

In the case where only one spouse is a U.S. citizen, then the Will and estate planning and structures are slightly different. As previously mentioned, a U.S. citizen spouse is subject to U.S. estate tax on worldwide assets in excess of $3.5 million US; however, a non-U.S. citizen spouse is subject to U.S. estate tax on **only U.S. situs assets** (e.g. U.S. real estate, U.S. stock).

As a result, if the U.S. citizen spouse has more than $3.5 million US in assets in his/her 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 his/her lifetime to “rebalance” the assets. (If U.S. situs assets are gifted, the non-U.S. spouse may sell these assets prior to his/her death to avoid their inclusion in the latter’s taxable U.S. estate.) The U.S. tax rules allow a U.S. citizen to gift up to $133,000 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 the rebalancing of assets between spouses; however, income attribution rules apply.

It may also make sense for the U.S. citizen spouse to gift to other family members up to the annual gift tax exclusion amount of $13,000 US per year. However, a U.S. citizen spouse and a non-U.S. citizen spouse cannot agree to split their gifts to a donee of up to $26,000 US per year. The strategy of gift splitting applies only where both spouses are either U.S. citizens or U.S. residents.

One of the reasons that the rebalancing strategy between spouses is so important is because the unlimited deferral of U.S. estate taxes on assets left between U.S. citizen spouses is not available when the surviving spouse is not a U.S. citizen. Fortunately there are two estate planning strategies that can help address this issue, and it also makes sense to consider a Credit Shelter Trust strategy even though the surviving spouse is not a U.S. citizen.

In the case of the latter, by having a Credit Shelter Trust provision in the U.S. citizen spouse’s Will, as previously discussed in the case of the two U.S. citizen spouses, you ensure that the first $3.5 million in assets of the U.S. citizen at death **and any future growth** thereon are never subject to U.S. estate tax. The reason that a Credit Shelter Trust may be beneficial to a surviving non-U.S. citizen spouse is to potentially shelter U.S. situs assets from U.S. estate tax and minimize 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).

There are two estate planning techniques that can be used to minimize or defer U.S. estate tax on the death of a high net worth U.S. citizen spouse who has assets in excess of $3.5 million US — where the assets are flowing to a non-U.S. citizen surviving spouse:

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

It is important to note at the outset that if the marital credit is used, then the QDOT strategy cannot be used.

MARITAL CREDIT UNDER THE TREATY

If certain conditions are met, a marital credit can be used to offset U.S. estate tax on property passing to a surviving spouse or a spousal trust. The amount of the marital credit cannot exceed the amount of the credit that the U.S. citizen spouse received on his/her death against the U.S. estate tax. The maximum credit that the U.S. citizen spouse can receive on his/her death against U.S. estate tax is $1,455,800 US (which equates to worldwide assets of $3.5 million US).

Therefore, under the Treaty, **another $1,455,800 US of credit** can be used 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 $1,455,800 US equates to **another $3.2 million US in 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 $6.7 million US in assets can flow to the deceased's beneficiaries with no U.S. estate tax payable ($3.5 million US to the Credit Shelter Trust and another $3.2 million US directly to the spouse or spousal trust).

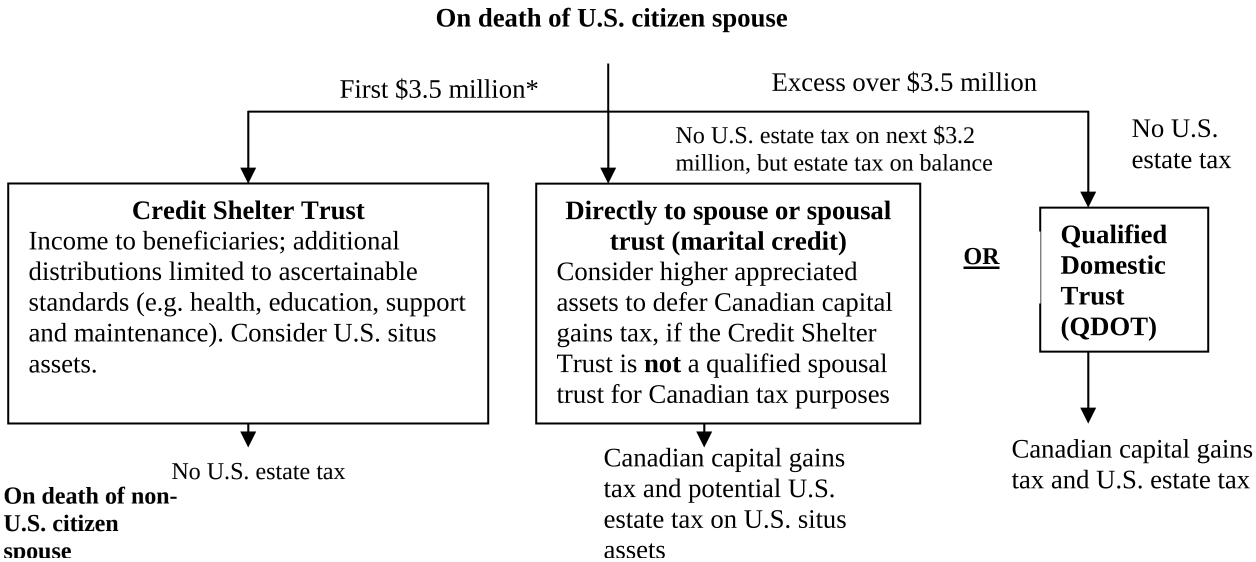
QUALIFIED DOMESTIC TRUST (QDOT)

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's 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 the QDOT. The deferral lasts until the 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. First, 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 U.S. bank or a bond or letter of credit must be provided in favour of the IRS. While 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 diagram demonstrates a typical estate plan and flow of assets after death where only one spouse is a U.S. citizen and the U.S. citizen spouse dies first: Article summary



* $3.5 million US is the U.S. estate tax exemption for deaths in 2009. 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 million 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 as to 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 $6.7 million 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 $6.7 million US, then a cost/benefit analysis needs to be undertaken by the executor to determine which strategy is more beneficial.

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

DYNASTY TRUST

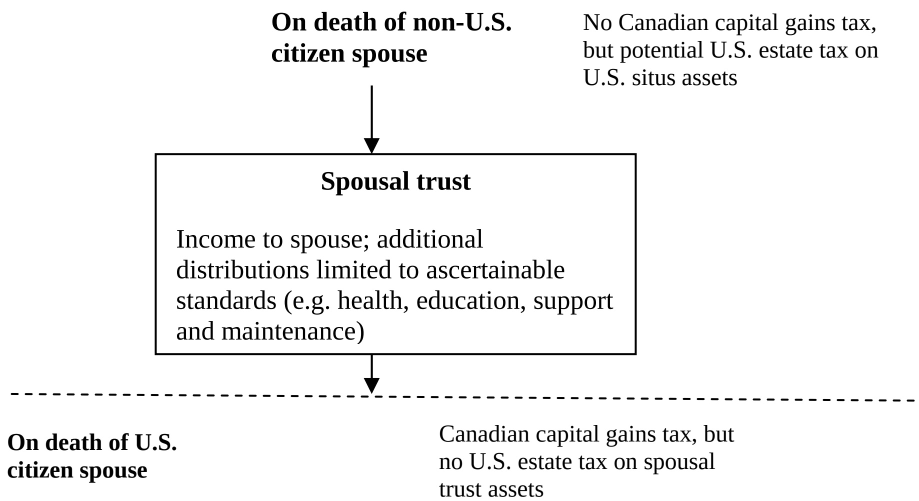
For the same reasons set out in the previous section, a U.S, citizen should consider the strategic benefits of Dynasty Trust planning.

C) ONLY ONE SPOUSE IS A U.S. CITIZEN AND THE NON-U.S. CITIZEN SPOUSE DIES FIRST

In the case where only one spouse is a U.S. citizen and the non-U.S. citizen spouse dies first, then the estate planning structure is different from the ones previously discussed.

If the couple's worldwide assets are expected to be greater than $3.5 million US, then it is imperative that the 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 strategy in this case is to arrange 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 must be payable to the surviving spouse; however, distributions of capital should 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 will not form part of his/her estate for U.S. estate tax purposes.

The following diagram demonstrates a typical estate plan and the flow of the assets after death where only one spouse is a U.S. citizen and the non-U.S. citizen spouse dies first. While not indicated in the diagram, it is also possible for the non-U.S. citizen spouse to leave assets to non-U.S. citizen children, either directly or in trust — though, unlike assets left to a spouse, Canadian capital gains tax is payable on gains of assets left to children.



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 $133,000 US per year to the non-U.S. citizen spouse and/or gifts of up to $13,000 per year to other beneficiaries. This allows more assets to accumulate in the name of the non-U.S. citizen spouse, which could 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 will 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 (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 2009), so this tax is very punitive.

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

However, gifts that are eligible for the $13,000 US annual gift tax exclusion are also exempt from the GSTT. In addition, there is a lifetime GSTT exemption of $3.5 million US for 2009 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 exemptions.

So this means that a wealthy U.S. citizen couple with three children and five grandchildren could make gifts of $208,000 US per year ($26,000 x 8) if they agree to split the gifts. This allows them to avoid gift tax and GSTT, and lower their taxable estate to help minimize U.S. estate tax.

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

For GSTT planning, Dynasty Trusts are often used, and the maximum amount that can be transferred into a testamentary Dynasty Trust without triggering unwanted GSTT or U.S. estate tax is the U.S. estate tax/GSTT exemption amount of $3.5 million US for 2009. The $3.5 million US exemption applies only 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, as discussed in the next section), the maximum amount that can be put into the trust to avoid gift tax, GSTT and future U.S. estate tax is $1 million 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, and there is no limit on 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 is for the U.S. citizen spouse to gift as many assets as possible (annual gift tax exclusion of $133,000 US) to the non-U.S. citizen spouse prior to death. Upon the death 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 put 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 will form part of the U.S. citizen's estate and potentially be subject to U.S. estate tax. This is quite punitive since life insurance proceeds are tax-free for Canadian tax purposes. But if the policy is 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 set up an irrevocable life insurance trust (ILIT), which owns the insurance policy instead of the U.S. citizen 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 is no U.S. estate tax for either the estate or the beneficiaries of an ILIT.

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

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

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

DYNASTY TRUSTS AND LIFE INSURANCE

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 great-grandchildren with no U.S. gift tax, estate tax or GSTT, Dynasty Trusts may be the solution. A Dynasty Trust will take advantage of or leverage 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 million US gift tax exemption, there will be no U.S. gift tax 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 will avoid U.S. estate tax on their deaths as well.

For Dynasty Trusts to be effective — such that the assets within the trust do not form part of any family member's (spouses', children's, grandchildren's, etc.) estate — it is imperative that the Dynasty Trust be structured properly by a qualified estate lawyer or accountant who has 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, these are the main issues to be aware of:

- 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).
- Be aware of the U.S. tax risks of owning Canadian-based mutual funds in a non-registered account.
- 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.
- If you have sufficient surplus assets, consider creating a Dynasty Trust and funding it with the amount available under your lifetime U.S. gift tax exemption.
- For high net worth U.S. citizens, ensure your Wills are properly drafted to maximize U.S. estate tax exemptions for both spouses (using the Credit Shelter Trust).

- Do not hold assets in JTWROS (not applicable in Quebec) if you have Credit Shelter Trust and spousal testamentary trust provisions in your Wills.

- For high net worth U.S. citizens, consider having an ILIT own your life insurance policies, rather than directly owning them yourself.

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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