Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Estate planning for U.S. citizens in Canada

Maximize your wealth with cross-border estate planning strategies

The United States (U.S.) tax system is composed of an estate, gift and generation-skipping transfer tax, collectively known as the U.S. transfer tax system. The transfer tax system can apply to U.S. and non-U.S citizens living in Canada. Therefore, estate planning must consider both Canadian and U.S. tax laws, making the planning more complex.

Did you know that U.S. citizenship can be acquired if you are born in the U.S. and if you are born outside the U.S. to a parent or parents who are U.S. citizens? You don't need to have a U.S. passport or to have lived or worked in the U.S. to acquire U.S. citizenship. If you are unsure of your status, you should contact a U.S. immigration lawyer who can review your situation and help you make a determination.

Please contact us for more information about the topics discussed in this article.

This article highlights some of the common specialized cross-border (Canadian-U.S.) estate planning considerations for U.S. citizens living in Canada and their families. The information provided is based on current tax laws; however, it is important to point out that these laws may change. Specifically, President Trump has indicated plans to repeal U.S. estate tax and possibly include a death tax based on accrued gains on assets owned on death that are in excess of US$10 million.

This article is for information purposes only and does not provide tax or legal advice. Many of the rules and strategies discussed may also apply to U.S. green card holders and U.S. resident aliens; however, the article does not cover all of the rules and strategies that are specific to them. Also, this article only addresses planning for U.S. federal estate and income tax purposes. Certain U.S. states may have their own transfer tax system and these are not covered in this article. It is imperative that you obtain professional advice from a qualified tax or legal advisor specializing in cross-border tax and estate planning before you act on any of the information provided in this article. This will ensure that your own circumstances have been properly considered and that action is taken on the latest information available.

The U.S. transfer tax system, which includes U.S. gift tax, U.S. estate tax and U.S. generation-skipping transfer tax (GSTT), applies to U.S. citizens due to their U.S. citizenship and non-U.S. citizens that are "domiciled" in the U.S.

Canadian income tax and U.S. transfer tax systems

Before you can consider the cross-border estate planning strategies that may be appropriate for you, you must first gain a basic understanding of the U.S. and Canadian tax systems. The following sections provide a basic overview.

Canadian income tax system

Canada does not have an estate or gift tax. Assets transferred by way of gifts made during your lifetime or bequests made upon your death are generally subject to Canadian income tax through the "deemed disposition" rules contained in the Canadian Income Tax Act. These rules require you to include in your income any net capital gains (gains less losses) accrued on the capital property you own as if you sold the property on the date of death or on the date it was gifted. The transfers to a spouse, directly or to a Canadian testamentary spousal trust through your Will, are exempt from these rules and may be transferred tax-free at your cost basis. In addition to the deemed disposition rules, income earned on property gifted during your lifetime to a spouse or minor child or grandchild may trigger the Canadian "income attribution" rules. These rules may require that you, as the transferor, pay tax on the income that is earned on the property gifted.

U.S. transfer tax system

The U.S. transfer tax system, which includes U.S. gift tax, U.S. estate tax and U.S. generation-skipping transfer tax (GSTT), applies to U.S. citizens due to their U.S. citizenship and non-U.S. citizens that are "domiciled" in the U.S. In certain circumstances these taxes can also apply to non-U.S. citizens, including Canadian residents and U.S. residents, who are not domiciled in the U.S. for transfer tax purposes. In the article, we refer to this group of individuals as "non-U.S. persons".

In order for a non-U.S. citizen to be considered U.S. domiciled for transfer tax purposes, physical presence in the U.S. is required, even if for a brief period of time, and the individual must have the intention to remain in the U.S. indefinitely. The determination of U.S. domicile is based on a question of the facts and circumstances. Case law identifies several factors that could be taken into account in determining U.S. domicile. Although holding a U.S. permanent resident visa (green-card) suggests U.S. domicile, it is not by itself definitive. Other factors may result in a green-card holder being considered non-domiciled. Domicile in one country continues until domicile is established in another country. Therefore, a non-U.S. citizen may be domiciled in the U.S. for U.S. transfer tax purposes regardless of which country they currently reside.

The following sections provide a general overview of U.S. gift, estate and GSTT.

U.S. gift tax

U.S. gift tax applies to a donor who makes taxable gifts during their lifetime. For donors who are U.S. citizens or persons domiciled in the U.S., gifts of any type of property may be considered taxable gifts. For non-U.S. persons, a taxable gift may only be triggered on gifts of U.S. situs property that qualifies as U.S. tangible property. This type of property consists of property typically located in the U.S. such as U.S. real estate, cars, boats, jewellery and cash physically located in the U.S. It does not include intangible property such as shares of a U.S. corporation. A gift that is not U.S. tangible property may still be subject to U.S. gift tax if it is considered to be a "disguised gift". For example, this could be a gift of intangible property (e.g. money transfer) from a donor that the recipient uses to purchase U.S. tangible property (e.g. U.S real estate) from the donor.

U.S. estate tax is determined based on a graduated tax rate system. The maximum tax rate of 40% is reached when the value of the taxable estate exceeds US$1 million.

Gift tax is calculated based on a graduated tax rate system with a maximum tax rate of 40% reached when the value of taxable gifts exceeds US$1 million. For both U.S. and non-U.S. citizens, the cumulative value of gifts made in a year must exceed certain annual exclusion thresholds before the gifts are considered taxable. For example, in 2017, the annual exclusion thresholds allow for tax-free gifting of up to US$14,000 to anyone each year. The annual exclusion increases to US$149,000 per year for gifts made to a non-U.S. citizen spouse. Only gifts in excess of these exclusions are taxable. U.S. gift tax does not apply to gifts made to a U.S. citizen spouse in any amount because there is an unlimited exclusion permitted.

A lifetime gift tax exemption (US$5.49 million for 2017) can be used offset the value of taxable gifts. However, the lifetime gift tax exemption is available only to U.S. citizens and persons domiciled in the U.S. Any portion of the lifetime gift tax exemption they use reduces the value of their U.S. estate tax exemption (discussed below) dollar for dollar.

For U.S. income tax purposes, the donor's cost basis of the gifted assets becomes the recipient's cost basis. Where the donor incurs a U.S. gift tax liability, there may be an increase in the cost basis to the recipient by a portion or all of the U.S. gift tax incurred. Double taxation may result from differences in the Canadian and U.S. tax treatment related to gifts made, which is discussed further in a separate section titled, "Lifetime Gifts".

U.S. estate tax

U.S. estate tax applies to the value of your taxable estate upon your death. The taxable estate for U.S. citizens and persons domiciled in the U.S. is the value of their worldwide assets. For non-U.S. persons, the taxable estate includes the value of their U.S. situs property only.

U.S. situs property includes both tangible and intangible U.S. situs property. U.S. situs property includes assets that have a U.S. connection or location, for example shares in a U.S. corporation, U.S. real estate or cash in a U.S. brokerage account. It also includes the value of debt obligations owed to you by U.S. persons and the value of your U.S. retirement plans. Life insurance, portfolio debt obligations and deposits in U.S. banks (not connected to a trade or business in the U.S.) are not considered U.S. situs for U.S. estate tax purposes.

U.S. estate tax is determined based on a graduated tax rate system. The maximum tax rate of 40% is reached when the value of the taxable estate exceeds US$1 million.

Every U.S. citizen and resident domiciled in the U.S. is entitled to a U.S. estate tax exemption. The estate tax exemption for 2017 amounts to US$5.49 million worth of taxable estate value. The exemption translates into a unified credit of US$2,141,800. Therefore, the U.S. estate tax liability for deaths in 2017 with a taxable estate not exceeding US$5.49 million is completely offset by the unified credit (assuming credits were not previously claimed against taxable gifts that reduced your estate tax exemption).

Even when the U.S. estate tax liability is in excess of the unified credit, the liability may be reduced by a credit for Canadian tax incurred on death on assets considered to have a Canadian location or connection. For example, a credit for foreign death taxes may be claimed for Canadian tax on death from the deemed disposition of real estate located in Canada or shares of a Canadian corporation. Generally, the estate must file a U.S. estate tax return if the value of the estate exceeds the estate tax exemption or the estate wishes to pass the benefits of the portability provisions (discussed later) to a surviving spouse.

U.S. generation-skipping transfer tax (GSTT) applies to taxable gifts or bequests that are made to a "skip individual" (e.g. a grandchild, a great grandchild, a more distant descendant or even a person who is at least 37 ½ years younger than the decedent).

For those who are non-U.S. persons, the U.S. estate tax rules provide a general exemption on the first US$60,000 worth of U.S. situs assets, which equates to a unified credit of US$18,000. In addition, non-U.S. persons who are Canadians residents are entitled to claim an enhanced prorated unified credit under the Canada-U.S. Income Tax Treaty ("Treaty"). The amount of the credit is calculated by multiplying the unified credit that applies to U.S. citizens by the ratio composed of the value of the Canadian's U.S. situs assets to the value of their worldwide estate. In effect, U.S. estate tax is avoided where the value of their U.S. situs assets does not exceed US$60,000 or the value of their worldwide estate does not exceed US$5.49 million (for the year 2017). A non-U.S. person's estate must file a U.S. estate tax return if the value of the U.S. situs assets exceeds US$60,000 (even if there is no U.S. estate tax liability). For assets that have a U.S. situs, such as shares of a U.S. corporation, the Treaty may provide additional tax relief for both U.S. and non-U.S. citizens in Canada. On the deceased's Canadian income tax return, a foreign tax credit may be claimed for U.S. estate tax paid on these assets.

If the assets in your taxable estate are left to a surviving U.S. citizen spouse, your estate may be eligible to claim an unlimited marital deduction to offset your U.S. estate tax liability. If your surviving spouse is not a U.S. citizen, your estate may be eligible to claim a marital credit. The ability to claim an unlimited marital deduction or the marital credit may also be possible where your taxable estate assets are transferred to certain types of trusts for the benefit of your surviving spouse provided certain conditions are met. For example, assets that are transferred to a qualifying spousal trust for a surviving U.S. citizen spouse may qualify for the unlimited marital deduction provided a Qualified Terminal Interest Property (QTIP) election is made by the trust. If the surviving spouse is not a U.S. citizen, the transfer to a qualifying spousal trust may qualify for the marital credit without the requirement to make a QTIP election. Trusts that make a QTIP election cannot be structured to provide U.S. estate tax protection for the surviving spouse. Alternatively, assets transferred to a Qualified Domestic Trust (QDOT) for the benefit of a non-U.S. citizen surviving spouse may qualify for the unlimited marital deduction that is otherwise only available when assets are transferred to a U.S. citizen spouse directly or to a spousal trust that makes a QTIP election.

There is a more detailed discussion later on in the article on the use of the unlimited marital deduction, martial credit, QTIP election and QDOT.

U.S. generation-skipping transfer tax (GSTT)

U.S. generation-skipping transfer tax (GSTT) applies to taxable gifts or bequests that are made to a "skip individual" (e.g. a grandchild, a great grandchild, a more distant descendant or even a person who is at least 37 ½ years younger than the decedent).

GSTT is levied at a flat tax rate equal to the highest marginal gift or estate tax rate in the year (which is 40% for 2017). It is levied in addition to U.S. gift or estate tax to prevent taxpayers from skipping a generation of U.S. gift or estate tax, which could otherwise be accomplished by making a gift or bequest to a skip individual.

The same annual exclusions and lifetime exemption for U.S. gift or estate tax discussed earlier applies for GSTT purposes. Therefore, GSTT will not apply if U.S. gift or estate tax does not apply. Although the lifetime U.S. gift and estate tax exemptions may only be claimed by U.S. citizens and persons domiciled in the U.S., a non-U.S. person is not specifically excluded from claiming the GSTT exemption of US$5.49 million (for the year 2017) for taxable gifts or bequests made to skip individuals. Therefore, it is possible for a non-U.S. person and their estate to eliminate GSTT and still incur U.S. gift or estate tax. This would be the case since no lifetime U.S. gift tax exemption is available and only a prorated unified credit for U.S. estate tax purposes may be claimed.

Common estate planning strategies for U.S. citizens in Canada

The following table lists the common cross-border estate planning strategies available to U.S. citizens in Canada. The strategies are based on a family's dynamics (i.e. both spouses are U.S. citizens, only one is and which one dies first). The strategies listed (which are not an exhaustive list) may be used to defer, reduce or potentially eliminate U.S. gift tax, estate tax or GSTT, and are discussed individually in greater detail in the following sections.

Common Estate Planning Strategies – U.S. Transfer Taxes

	Planning based on family dynamics		
	Planning by each U.S. citizen spouse where both are U.S. citizens	Planning by a U.S. citizen spouse where a non-U.S. citizen spouse may be the survivor	Planning by a non-U.S. citizen spouse where a U.S. citizen spouse may be the survivor
Portability Provisions	√		
Credit Shelter Trust (CST)	√	√	
Marital Credit	√	√	√
Qualified Domestic Trust (QDOT)		√	
Lifetime Gifts	√	√	√
Dynasty Trust	√	√	√
Irrevocable Life Insurance Trust (ILIT)	√	√	√
Canadian Testamentary Spousal Trust	√	√	√
Charitable Donations	√	√	√

Portability provisions

The portability provisions allow a surviving U.S. citizen or U.S. domiciled spouse to use their deceased spouse's unused U.S. gift or estate tax exemptions as well as their own to minimize or avoid U.S. gift and estate taxes. The portability provisions are available to U.S. citizen spouses and also to spouses who are U.S. persons domiciled in the U.S. An election to transfer the unused exemptions to the surviving spouse must be made on the U.S. estate tax return of the first spouse to die.

For a U.S. person who dies in 2017, the portability provisions provide the surviving U.S. spouse with the potential to transfer up to US$10.98 million of wealth to their beneficiaries without paying U.S. gift or estate tax. The US$10.98 million is comprised of US$5.49 million of their deceased spouse's unused

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lifetime gift or estate tax exemption and another US$5.49 million of their own exemption. The unused exemptions cannot be used to shelter GSTT triggered when making gifts or bequests to a skip individual.

The portability provisions are generally useful for couples with relatively small estates where the assets are not expected to grow beyond the gift and estate tax exemption thresholds. This is because the provisions cannot insulate assets and future growth in excess of the thresholds from U.S. gift and estate taxes. Couples with larger estates who rely on these provisions risk greater exposure to U.S. estate tax for themselves and their beneficiaries. For larger estates, other strategies discussed in the article may be more effective in protecting the assets transferred to a beneficiary and future growth of those assets from U.S. estate tax.

Credit shelter trust (CST)

U.S. citizens and those domiciled in the U.S. can protect their heirs from U.S. estate tax exposure by leaving assets to them in a CST, also known as a “bypass trust” or “A/B trust”. When a beneficiary of a CST dies, the value of the assets in the trust (assets transferred in and any future growth) is excluded in determining the beneficiary’s U.S. estate tax liability.

A CST is an irrevocable testamentary trust created through your Will for the benefit of your beneficiaries, such as your spouse, children and/or grandchildren. Your spouse may be appointed the sole trustee or one of many trustees. Since the trust is funded with assets from your estate, it is important that the assets you intend to transfer to the CST not be held in joint accounts.

In order for the assets in the CST to be excluded from the taxable estate of a deceased beneficiary, the beneficiary must not have a general power of appointment over the assets of the trust. A general power of appointment is such a power exercisable in favour of the beneficiary, the beneficiary’s estate, and creditors of the beneficiary or the beneficiary’s estate.

Income earned in the trust may be distributed to a beneficiary during their lifetime. However, the beneficiary’s access to the capital of the trust should be restricted. There are limited powers that allow a beneficiary to request a trustee to distribute, annually, 5% of trust assets or $5,000, whichever is greater. It is also possible to structure the CST to allow a beneficiary to access the capital of the trust without creating a general power of appointment by including an “ascertainable standards” clause that restricts the use of capital for health, education, support or maintenance. An independent trustee is permitted to make additional payments of capital or income from the trust to a beneficiary. An independent trustee is someone who has not contributed to, and cannot benefit from the trust. They must not be a person related to the settlor or beneficiary nor an employee of either. The role of an independent trustee may be filled by a corporate trustee that is a financial institution or even a friend of the family.

For Canadian tax purposes, the transfer of the assets upon your death to a trust other than a Canadian testamentary spousal trust may result in a deemed disposition of those assets and taxation of the accrued gains and losses. The assets in the trust will also be subject to a deemed disposition every 21 years of the existence of the trust. However, it may be possible to structure a CST in your Will to qualify as a Canadian testamentary spousal trust in order to benefit from the tax-free rollover and avoidance of the 21-year deemed disposition rules. One of the requirements is that only your surviving spouse is entitled to receive all of the income from the trust during their lifetime and no other person can benefit from the income or the capital of the trust during this time. Other heirs such as children and grandchildren can receive distributions from the spousal trust after the death of the surviving spouse or through successive trusts that are created upon the death of the surviving spouse. If your wish is that beneficiaries other than your spouse benefit from your estate prior to the death of your surviving spouse, you may consider providing for them through outright distributions from your estate or distributions to separate trusts. Canadian testamentary spousal trusts are discussed in greater detail later in a separate section of the article.

When a U.S. citizen's surviving spouse is a U.S. citizen

Upon your death, the assets transferred to a CST for the benefit of your surviving U.S. citizen spouse and future growth of these assets will be protected from U.S. estate tax in the event of your surviving U.S. citizen spouse’s death. In order for the CST to provide U.S. estate tax protection, it cannot make a QTIP election and therefore your estate cannot claim the unlimited marital deduction. As such, the value of the assets transferred to the CST on your death is included in determining your own U.S. estate tax liability. However, U.S. estate tax on the assets transferred to the CST can be completely offset with your U.S. estate tax exemption if your estate plan transfers only assets valued up to this exemption to the CST. U.S. estate tax can also be avoided by claiming the unlimited marital deduction on assets valued in excess of your U.S. estate tax exemption if these assets are transferred directly to your surviving spouse or to another spousal trust that makes the QTIP election. The QTIP election essentially provides your surviving spouse with a lifetime income interest in the property of the spousal trust. Your surviving spouse

When the maximum estate tax exemption and marital credit are claimed by a U.S. citizen, it is possible to transfer approximately US$10.84 million in assets to a surviving non-U.S. citizen spouse directly or to a spousal trust, free of U.S. estate tax.

must also be paid the annual income of the spousal trust and must be the only beneficiary that can access the capital during their lifetime. As indicated earlier, it is possible to structure the CST and a spousal trust as Canadian testamentary spousal trusts for Canadian tax purposes. Upon your surviving spouse's death the assets in the CST are protected from U.S. estate tax. Spousal trusts that make a QTIP election cannot be structured to provide U.S. estate tax protection so the assets in them are not protected from U.S. estate tax. However, these spousal trusts can provide other estate planning benefits such as probate tax avoidance and creditor protection.

Refer to Appendix 1 for an example of an estate plan using a CST where both spouses are U.S. citizens.

When a U.S. citizen's surviving spouse is not a U.S. citizen

Under the Treaty, a U.S. citizen spouse's estate may claim the marital credit in respect of assets transferred to a non-U.S. citizen surviving spouse directly or to a spousal trust. For assets transferred to a spousal trust, the Treaty removes the need to make a QTIP election in order to claim the marital credit. This may provide an opportunity for the spousal trust for the non-U.S. citizen spouse to be structured with U.S. estate tax protection for the assets transferred in and the future growth of those assets.

A U.S. citizen can transfer assets up to their U.S. estate tax exemption to a CST for the benefit of their non-U.S. citizen spouse without incurring U.S. estate tax. Assets in excess of this amount up to the marital credit may be transferred free of U.S. estate tax to either the CST (set up as a spousal trust) or to a separate spousal trust. Assets in excess of your estate tax exemption and the marital credit will be subject to U.S. estate tax. However, since a non-U.S. citizen is subject to U.S. estate tax only on U.S. situs assets, if you can transfer all the U.S. situs assets to these trusts you will be able to protect these assets and future growth from U.S. estate tax upon your spouse's death.

When the maximum estate tax exemption and marital credit are claimed by a U.S. citizen, it is possible to transfer approximately US$10.84 million in assets to a surviving non-U.S. citizen spouse directly or to a spousal trust, free of U.S. estate tax. For example, a U.S. citizen may transfer US$5.49 million worth of assets (2017 rates), by claiming the maximum unified credit of US$2,141,800, and another US$5.35 million (i.e. US$2,141,800 divided by 40% maximum U.S. estate tax rate) by claiming the maximum marital credit of US$2,141,800, and incur no U.S. estate tax.

If your estate value will significantly exceed US$10.84 million and therefore U.S. estate tax will apply on the excess, the Treaty provides relief by giving your estate the option to claim an unlimited marital deduction in lieu of the martial credit. In order to qualify for the unlimited marital deduction, the value of the assets in excess of your U.S. estate tax exemption must be transferred to a QDOT for the benefit of your non-U.S. citizen spouse.

The use of the unlimited marital deduction through the use of the QDOT only defers U.S. estate tax. Therefore, this option is generally only considered in cases where a significant U.S. estate tax liability would be incurred by claiming the martial credit. The marital credit and QDOT are discussed in greater detail in the next two sections.

For Canadian tax purposes, similar to the CST and spousal trust, it is possible (with greater complexity) to structure the QDOT as a Canadian testamentary spousal trust.

Under the Treaty, the estate of a resident of Canada or the U.S. (whether or not the deceased is a U.S. citizen) may qualify for the martial credit.

Refer to Appendix 2 for an example of an estate plan where only one spouse is a U.S. citizen and they are survived by a non-U.S. citizen spouse. The example illustrates the use of a CST, and the option to implement a separate spousal trust using the marital credit or a QDOT with the unlimited marital deduction.

Marital credit

Under the Treaty, the estate of a resident of Canada or the U.S. (whether or not the deceased is a U.S. citizen) may qualify for the martial credit (which effectively doubles the unified credit claimed) when assets subject to U.S. estate tax are transferred to a U.S. or Canadian resident spouse (either directly or to a spousal trust). The surviving spouse must be a resident of the U.S. or Canada and if both spouses are residents of the U.S. at the time of death, at least one spouse must be a Canadian citizen. For example, the marital credit may be claimed when assets are transferred to a non-U.S. citizen spouse, which can also include a spouse who is a U.S. green-card holder or U.S. resident.

Qualified domestic trust (QDOT)

A QDOT is a type of trust that may be implemented by a U.S. citizen or a non-U.S. citizen to defer U.S. estate tax on assets left to a non-U.S. citizen spouse. It can be implemented in your Will or post mortem by your executor, if they do so within 9 months of your death. U.S. estate tax is deferred because assets transferred to a QDOT qualify for the unlimited marital deduction (a deduction otherwise available when the surviving spouse is a U.S. citizen).

The surviving spouse must be the sole beneficiary of the QDOT during their lifetime. Other heirs such as children and grandchildren can receive assets in the QDOT after the death of the surviving spouse. Alternatively, the assets may be transferred to successive trusts for their benefit. If your wish is that beneficiaries other than your spouse benefit from your estate prior to the death of your surviving spouse, you may consider providing for them through outright distributions from your estate or distributions to separate trusts.

Distributions of income earned in the QDOT may be made to your surviving spouse annually without triggering U.S. estate tax. However, U.S. estate tax may be triggered when: 1) capital is distributed to your surviving spouse and 2) your spouse dies. The U.S. estate tax will be calculated based on the fair market value at the time capital is distributed to your surviving spouse during their lifetime and on the value of assets in the QDOT at the time of their death. Therefore, if the value of the assets increases, the estate liability calculated will be higher than if the tax had been paid at the time of your death. The U.S. estate tax liability is based on the estate tax rates that existed at the date of your death (or an alternate valuation date, if applicable), not those that existed in the year capital is distributed or the year of your surviving spouse's death.

If your surviving spouse becomes a U.S. citizen during the life of the QDOT, the QDOT is able to distribute capital to the U.S. citizen surviving spouse free of U.S. estate tax, since the value of these assets may eventually be included in the estate of the surviving spouse upon their death.

There are a number of criteria that must be met for a QDOT to qualify for the deferral. 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 US$2 million at the time of your death (or an alternate valuation date, if applicable) at least one trustee may need to be a U.S. bank, or a bond or letter of credit may need to be provided in favour of the Internal Revenue Service (IRS).

A QDOT set up through your Will may

potentially be structured to qualify as a Canadian testamentary spousal trust (those created post mortem cannot). When the surviving spouse is a non-U.S. citizen, your estate will have the option to claim either the marital credit or the unlimited marital deduction with the QDOT (not both). Therefore, it is important to draft your Will to provide your executor flexibility to choose the most appropriate option. If your U.S. estate tax liability will be significant after taking into consideration claiming the marital credit and your surviving spouse is expected to live a long time, your estate may instead consider claiming the unlimited marital deduction to defer U.S. estate tax with the use of a QDOT.

Speak to a professional cross-border tax and/or legal advisor for advice on how to structure and incorporate a QDOT in your estate planning where appropriate.

Lifetime gifts

For U.S. or non-U.S. citizens, U.S. estate tax may be avoided or minimized if a sufficient amount of property is gifted before death to bring the value of your worldwide estate, at or below the U.S. estate tax exemption threshold. For non-U.S. citizens in particular, since they are subject to U.S. estate tax on U.S. situs assets only, an additional strategy for them would include gifting U.S. situs property to bring the value of U.S. situs assets owned below the US$60,000 exemption threshold.

When the cumulative value of the gifts made in a year to a specific individual does not exceed certain annual exclusion thresholds, the gift will not be taxable. For 2017, gifts up to US$14,000 per year to any person (such as a child or grandchild) are not taxable. If the gifts are made to a non-U.S. citizen spouse, the annual threshold for non-taxable gifts increases to US$149,000 per year. There is also an unlimited exclusion from U.S. gift tax on property gifted to a U.S. citizen spouse.

Non-U.S. citizens are subject to U.S. gift tax only on gifts of tangible U.S. situs property such as U.S. real estate, cars, boats, artwork, jewelry or cash located in a safety deposit box in the U.S. or in a non-deposit account at a U.S. financial institution. Therefore, to reduce exposure to U.S. estate tax, non-U.S. citizens may consider receiving non-U.S. situs property and gifting U.S. situs property ensuring that gifts of tangible U.S. situs property do not exceed the annual exclusion thresholds.

When property is gifted, various U.S. and Canadian taxes may be triggered such as U.S. gift tax, GSTT, Canadian tax on accrued capital gains as a result of the deemed disposition rules, and the Canadian income attribution rules. Due to differences in the tax laws in the U.S. compared to those in Canada, the potential for double tax may result at the time the property is gifted, when income is subsequently earned from the property, and when it is sold.

When property is gifted to someone other than your spouse, Canadian income tax may be triggered because of the deemed disposition tax rules. If U.S. gift tax is also triggered, double taxation may result since you cannot offset U.S. gift tax against Canadian income tax and vice versa. For example, if you gift U.S. real estate to a child, you cannot claim a foreign tax credit for U.S. gift tax incurred on your Canadian income tax return against the Canadian tax on the capital gain also triggered. Also, where a U.S. citizen gifts Canadian real estate property to a child, they will not be able to reduce the U.S. gift tax with a credit for Canadian income tax incurred on the capital gain triggered.

If the Canadian income attribution rules apply to income and capital gains earned on property you have gifted, double taxation may also result. This is because there will be different individuals being taxed under the Canadian and U.S. tax laws. For example, the Canadian income attribution tax rules require you to be taxed on interest, dividends and capital gains earned on the property you have gifted to your spouse. If the property is a gift to a minor child or a grandchild the income attribution rules apply only to the interest and dividends earned on the property, not the capital gains. In contrast, for U.S. income tax purposes, generally your spouse, child or grandchild who owns the property may be subject to U.S. income tax. When different individuals are taxed on the income or gain, foreign tax credits claims may not be possible to minimize or avoid double taxation.

When the property gifted is eventually sold, double tax can result due to the timing of the taxation of the accrued gains on the property. For example, if you were to gift property to someone other than your spouse you would pay Canadian tax on the accrued gains in the year the gift is made. The cost basis of the property to the individual who receives the gift is bumped-up to the fair market value (FMV) of the property. For U.S. income tax purposes, no income tax would be triggered on the accrued gains when the property is gifted and there is no automatic bump-up in the cost basis to FMV. Your cost basis of the gifted assets for U.S. tax purposes becomes the recipient's cost basis. If the gift is subject to U.S. gift tax, there may be an increase to the cost basis for the individual who received the property by a portion or all of the U.S. gift tax you incur. When the property is sold, the individual you gifted the property to is subject to U.S. income tax on the accrued gains. Since accrued gains may have already been subject to Canadian income tax in the year the gift was made, there is a potential for double tax since foreign tax credits cannot be claimed. To

A U.S. citizen can potentially minimize their exposure to U.S. estate tax by rebalancing assets with their non-U.S. citizen spouse.

minimize the double tax, it is possible to make an election under the Treaty in the year the gift is made to treat the gift as a disposition for U.S. income tax purposes. This will bump-up the cost basis for U.S. tax purposes to FMV for the individual receiving the property. Since U.S. and Canadian income tax occurs in the same year, it is then possible to claim foreign tax credits to reduce or eliminate double taxation. This election would make sense where the U.S. income tax triggered on the accrued gains can be fully recouped through the claiming of foreign tax credits.

If a gift of property will result in significant exposure to double taxation, consider selling the property instead of gifting it. Selling the property avoids U.S. gift tax and may reduce your exposure to double taxation as you will pay U.S. and Canadian tax on the accrued gains in the same year.

Gift splitting

Where you and your spouse are both U.S. citizens, you may use gift splitting to reduce your taxable estate. Gift splitting allows one spouse to fund the entire amount of the gift, but to have the gift treated as being made one-half by each spouse. For example, one spouse makes a gift of US$28,000 with their own assets to a child but each spouse is treated as having made a gift of US$14,000 to the child. Since the value of gift made by each spouse is within the annual gift tax exclusion threshold, the gifts are not taxable.

Gift splitting is only made possible by filing a U.S. gift tax return to make the election to split the gift. It cannot be used when one spouse is not a U.S. citizen unless that spouse is domiciled in the U.S. (i.e. considered to be a U.S. resident for U.S. transfer tax purposes).

Being able to split gifts may allow the gifting of significant assets without triggering U.S. gift tax. For example, a U.S. citizen couple with three children may gift up to US$84,000 (US$28,000 x 3) annually without triggering U.S. gift tax. If they also make gifts to three grandchildren they will be able to make tax-free gifts of US$168,000 (US$28,000 x 6) annually. These gifts can also be made to the spouses of your children or grandchildren, which can further increase the amount of tax-free gifts that can be made.

Payments not considered gifts

If you are a U.S. citizen or a domiciled U.S. resident, you can make direct payments on behalf of a child or grandchild to educational organizations for tuition expenses (e.g. college tuition) or to a healthcare provider for medical services (e.g. braces for teeth). These payments may exceed the annual exclusion amounts since they are not considered to be gifts. The funds must not be given directly to the child or grandchild to pay for these expenses otherwise the payment will be considered a gift. Paying for books, supplies, room and board, or other types of educational expenses directly would be considered gifts as they would not qualify as tuition payments.

Rebalancing non-U.S. situs assets with your non-U.S. citizen spouse

A U.S. citizen can potentially minimize their exposure to U.S. estate tax by rebalancing assets with their non-U.S. citizen spouse. A rebalancing strategy could involve making tax-free gifts annually that do not exceed the annual exclusion amount. Since U.S. estate tax for non-U.S. citizens applies only to U.S. situs assets, gifts of non-U.S. situs assets may be chosen over U.S. situs ones.

Generally, it is not advisable to make gifts in excess of the annual exclusions. Doing so would require the use of your lifetime gift tax exemption to avoid U.S. gift tax and every dollar used reduces your U.S. estate tax exemption. However, there may be situations where it could

If you are a U.S. citizen living in Canada and you own a home (i.e. a non-U.S. situs asset) in sole or joint name, you may benefit (for U.S. estate and income tax purposes) from gifting your portion of ownership in the home to your non-U.S. citizen spouse, especially if the value of the home has increased substantially and your intention is to eventually sell the home.

make sense to make taxable gifts that will require that you use your lifetime exemption. For example, if you are a U.S. citizen living in Canada and you own a home (i.e. a non-U.S. situs asset) in sole or joint name, you may benefit (for U.S. estate and income tax purposes) from gifting your portion of ownership in the home to your non-U.S. citizen spouse, especially if the value of the home has increased substantially and your intention is to eventually sell the home. For U.S. gift tax purposes the transfer will be considered a taxable gift on the value that exceeds the annual exclusion. You may use your lifetime gift tax exemption to minimize or eliminate the U.S. gift tax on the excess amount. If you die after the property is gifted to your spouse it will not be included in determining your U.S. estate tax since you no longer own the property.

For Canadian income tax purposes, if you sell your home and you have sole or joint ownership, there may be no Canadian income tax on the capital gain if the home qualifies as your principal residence. However, for U.S. income tax purposes, while there are similar tax rules that allow for an exclusion of the capital gain on a principal residence, different criteria must be met to qualify, and the amount of the capital gain that can be excluded is subject to a limitation. Therefore, there may be U.S. income tax on the amount of the capital gain that exceeds the limitation. For example, it is common for a U.S. citizen married to a non-U.S. citizen to file their U.S. income tax return separately, selecting the filing status, “married filing separate” because it requires only the U.S. citizen to file a U.S. return. The U.S. citizen who files separately qualifies for an exclusion amount of up to US$250,000 of the capital gain triggered on the sale of a principal residence. If the capital gain on the sale exceeds this amount, the excess will be subject to U.S. income tax.

If this couple rebalanced ownership through gifting of the home to the non-U.S. citizen spouse, the capital gain on the eventual sale of the home in the future may avoid both Canadian and U.S. income tax. To benefit the planning must be implemented at least 2 years in advance of the sale; otherwise, U.S. tax law may require that the U.S. citizen report the gain on the sale for U.S. income tax purposes.

When the strategy can be implemented successfully, the U.S. income tax saved is equal to the U.S. income tax rate that would otherwise apply to the excess capital gain. For example, a home that has increased in value by US$1 million dollars would result in U.S. income tax savings of approximately US$178,500 assuming a 23.8% tax rate (i.e. take proceeds of US$1 million less the US$250,000 exclusion and multiply by 23.8%, which is composed of a 20% maximum long-term capital gains income tax rate plus the 3.8% net investment tax). These tax savings must be weighed against costs such as legal fees, potential land transfer tax and probate tax exposure resulting from sole ownership, as well as the U.S. gift tax that may be triggered.

U.S. citizens should speak to their tax advisors for advice on whether a particular rebalancing strategy makes sense and to ensure the strategy is implemented properly.

Concerns with making larger gifts

Outright gifts received by your beneficiaries may be exposed to U.S. estate tax in their hands. Also, you may not be comfortable with the idea of making larger outright gifts and giving up control of a significant portion of your wealth. To address these concerns, you may consider making gifts to a “Dynasty Trust”.

Dynasty Trust

A Dynasty Trust (sometimes referred to as a Generation-Skipping Transfer

Trust) is a special type of irrevocable trust. Assets funding the trust may potentially be subject to U.S. estate or U.S. gift tax; however, the trust maximizes the amount of wealth that can be transferred from thereon, generation to generation without exposing it and any future growth to U.S. estate tax. The trust also serves to protect the assets from uncontrolled spending by your beneficiaries and the potential claims of beneficiaries' creditors and their spouses (in the case of matrimonial disputes). Probate tax and estate administration delays may also be avoided with respect to assets in a Dynasty Trust.

A Dynasty Trust can be created during your lifetime as an inter-vivos trust or upon your death as a testamentary trust created by your Will. Similar to the CST, in order to provide U.S. estate tax protection, a beneficiary of the trust must not be given broad powers to access the trust assets. Therefore, a beneficiary cannot be given a general power of appointment. The trust can provide limited powers that allow a beneficiary to request a trustee to distribute, annually, up to 5% of trust assets or $5,000, whichever is greater. In addition, the beneficiary can be given the power to require trustees to make distributions of capital if they are made within "ascertainable standards" for health, education, support or maintenance. A beneficiary can be a trustee provided that they are provided only with these limited powers. For greater flexibility, it is also possible to include an independent trustee that is not bound by the ascertainable standards provision for distributing capital to the beneficiaries.

In order for the settlor to avoid U.S. estate tax on assets transferred to an inter-vivos trust, the settlor must not retain a life interest in the assets transferred to the trust and the gift cannot be revocable. This means the settlor cannot maintain a right to income, possession or enjoyment, the right to designate who will enjoy the assets or the right to take the assets back. In addition, the settlor cannot have the power to determine beneficial enjoyment of the trust assets after the trust has been settled. As a result, the settlor is generally not a beneficiary or trustee of the Dynasty Trust. However, it may be possible for the settlor to be a beneficiary if the trust is structured properly as a self-settled trust. Here, the settlor is one of a group of beneficiaries that is typically comprised of the settlor and their children and perhaps grandchildren. Certain precautions need to be taken when creating a self-settled trust where protection from U.S. transfer tax is desired. First, the settlor of the trust cannot retain a life interest in the assets of the trust. Second, the trust must be governed by the laws of a jurisdiction that permits self-settled trusts and allows these trusts to benefit from the U.S. "spendthrift trust" rules. The spendthrift rules protect the trust assets from the creditors of the beneficiaries of the trust and ordinarily would not apply in the case of self-settled trusts. However, there are a number of foreign jurisdictions, as well as U.S. states including Delaware, Alaska and Nevada, that have enacted exceptions for self-settled trusts to benefit from the U.S. spendthrift trust rules. So provided the settlor does not have a "right" to the trust assets, it may be possible that they can enjoy the "use" of them. This can be a complicated distinction that requires very specific advice from a qualified cross border tax and/or legal professional to be successful. One way of addressing this issue is through the choice of trustee (e.g. use of an independent trustee) and the nature of the trustee's powers to make trust distributions. To maintain their lifestyles for the long term, settlors should also consider retaining sufficient assets outside of the Dynasty Trust in their own name.

A Dynasty Trust can be created during your lifetime as an inter-vivos trust or upon your death as a testamentary trust created by your Will.

Dynasty Trusts may be set up as U.S. trusts for U.S. beneficiaries living in the U.S. If the trust is considered U.S. resident and not Canadian resident, the trust avoids the Canadian 21-year deemed disposition rule that applies to Canadian resident trusts. However, the Canadian deemed disposition rule would continue to apply to Canadian real property and business assets even if these assets are in a U.S. resident trust. In addition, if set up as a U.S. trust, the Dynasty Trust will avoid the punitive U.S. income tax rules known as the "throw-back rules" that apply to "foreign non-grantor trusts" as well as the annual reporting rules relating to "foreign grantor trusts".

In simplified terms, the throw-back rules apply to U.S. beneficiaries of a foreign non-grantor trust on distributions of accumulated income (i.e. income of the trust that is accumulated and distributed in a different calendar year). In general, a foreign non-grantor trust is a non-U.S. trust with U.S. beneficiaries where the settlor or transferor of property is not a U.S. person, and if still alive, does not maintain a reversionary interest in the assets of the trust. When the U.S. throw-back rules apply to distributions of accumulated income to a U.S. beneficiary, accumulated income and capital gains distributed are taxed at the beneficiary's marginal U.S. tax rate (i.e. the income does not maintain its character and does not benefit from potentially lower tax rates). An interest charge is also applied on the tax owed because U.S. tax was not paid during the period the income was accumulating in the trust. In comparison, a foreign grantor trust is a non-U.S. trust where the settlor or transferor of property to the trust is treated as the owner of the property. As a result, the settlor is taxed on the income earned by the trust annually (whether or not the income is distributed from the trust to a beneficiary).

While assets that remain in a Dynasty Trust are protected from U.S. estate tax, income earned in a U.S. resident non-grantor trust is still subject to U.S. income tax. The trustee decides whether the income is to be taxed in the U.S. trust or distributed to a beneficiary and taxed in their hands. While the U.S. income tax rates that apply to income taxed in the trust or in a U.S. beneficiary's hands are similar, the tax brackets for income taxed in the trust are much more compressed as compared to those for an individual. This may result in a larger U.S. income tax liability if income is taxed in the trust.

For Canadian tax purposes, a Dynasty Trust set up to include beneficiaries other than a spouse cannot qualify as a Canadian testamentary spousal trust. Therefore, the transfer of assets to a Dynasty Trust by a resident of Canada is subject to the Canadian deemed disposition tax rules, which would trigger Canadian income tax on accrued capital gains.

The alternative to implementing a Dynasty Trust would be to transfer assets to a Canadian testamentary spousal trust (discussed in more detail later). This trust can be structured with provisions that provide protection from U.S. estate tax for a spouse who must be the sole beneficiary and allow for the tax-free transfer of assets with accrued gains to the trust. Your children and grandchildren can be successive beneficiaries of the capital, which can be transferred to a Dynasty Trust once the surviving spouse dies. However, if your wish is that your children and grandchildren benefit from your estate prior to the death of your surviving spouse, you may provide for them through outright distributions from your estate or allocate a portion of your estate to a Dynasty Trust.

If you and your beneficiaries are residents of Canada, the Canadian income attribution rules may apply to trust distributions made to minors or to a spouse. Furthermore, if you or your beneficiaries are residents of Canada, a trust set up as a U.S. resident trust may be deemed to be a Canadian resident trust. The 21-year deemed disposition tax rule that applies to Canadian resident trusts also applies to trusts that are deemed to be Canadian resident trusts. A testamentary spousal trust set up as a U.S. trust that is deemed to be resident in Canada will not qualify for a tax-free rollover of assets with accrued gains from your spouse's estate. When a U.S. trust is deemed to be a Canadian trust, it may be considered a dual resident trust subject to taxation in both Canada and the U.S. Fortunately, offsetting foreign tax credits to avoid or reduce double taxation are permitted. When a Canadian resident settlor of the trust dies and the estate is wound up, the trust may no longer be deemed resident of Canada (unless the trust has a Canadian resident beneficiary).

It is imperative that a Dynasty Trust be structured to take into account your specific circumstances. It must be structured properly by a qualified cross-border estate tax professional that has expertise in this area. Speak to your tax and legal advisors regarding the appropriateness of a Dynasty Trust and how to implement one in your estate planning.

U.S. citizens funding a Dynasty Trust

U.S. gift tax, estate tax or GSTT may be triggered on gifts or bequests made to a Dynasty Trust. These taxes may be reduced or eliminated by using your lifetime gift, estate tax and GSTT exemptions or the annual gift and GSTT exclusions. As a U.S. citizen, for 2017, you can transfer US$5.49 million to a Dynasty Trust without triggering gift tax or GSTT by using your lifetime gift tax exemption, assuming you made no prior taxable gifts.

Using your lifetime gift tax exemption to transfer assets to the trust during

To minimize exposure to U.S. estate tax, an ILIT may be used to hold ownership of a life insurance policy.

your lifetime can maximize the amount of assets that are protected from U.S. estate tax. This is because any future growth of the assets while in the trust is also protected. If your net worth is close to or exceeds the exemption, you can protect a greater amount of assets from U.S. estate tax if you transfer them to the trust during your lifetime. If you wait until your death and the assets have continued to grow in value, the maximum that can be transferred and protected is limited to your U.S. estate tax exemption. Any excess wealth, including any growth, will be exposed to U.S. estate tax and potentially the GSTT. If you or the beneficiaries are residents of Canada, the Canadian tax implications discussed earlier must be considered.

Non-U.S. citizens funding a Dynasty Trust

As a non-U.S. person, you can fund a Dynasty Trust during your lifetime without incurring U.S. gift tax or GSTT (provided the assets gifted are not U.S. tangible property). You may also fund a Dynasty Trust through your Will.

Where your beneficiaries reside in the U.S., there are benefits to funding a Dynasty Trust that is resident in the U.S. upon your death instead of during your lifetime. First, a testamentary Dynasty Trust that is resident in the U.S. may not be subject to the application of the Canadian non-resident trust rules, unless a beneficiary is resident in Canada. Second, the Canadian 21-year deemed disposition rule will not apply, unless the trust owns Canadian real property or Canadian business assets.

Irrevocable life insurance trust (ILIT)

To minimize exposure to U.S. estate tax, an ILIT may be used to hold ownership of a life insurance policy. An ILIT is an inter-vivos trust structured to protect you from U.S. estate tax exposure that may result from outright ownership of a life insurance policy or through "incidents of ownership" in the policy. Incidents of ownership may result from having the ability to name or change beneficiaries, borrow against the policy, access the cash value and assign or cancel the policy. You cannot be the trustee of the ILIT without creating incidents of ownership. You can, however, contribute cash to the ILIT in order to fund the purchase of the life insurance policy.

When a U.S. or non-U.S. person, who is the life insured on a policy, dies owning the policy or having incidents of ownership in the policy, the death benefit paid will be included in their worldwide estate value for purposes of determining U.S. estate tax. For a U.S. citizen or domiciliary, the death benefit is subject to U.S. estate tax. For non-U.S. persons who are Canadian residents, the death benefit reduces the amount of the unified credit that may be claimed to minimize their U.S. estate tax liability.

Having your spouse or a corporation own the life insurance policy of which you are the insured may reduce your exposure to U.S. estate tax. However, if your spouse owns the policy and predeceases you, the policy will need to be transferred to someone other than yourself and this may trigger income tax. If you provide your spouse, who will own the policy, with the funds to facilitate the purchase of the policy, you may create incidents of ownership. If a corporation owns the policy, exposure to U.S. estate tax still exists if the life insured has ownership in the corporation. For example, if the life insured is a U.S. citizen who owns more than 50% of the shares of the corporation, it is possible they will be considered to have incidents of ownership in the policy. Even where ownership in the corporation is less than 50%, the value of the life insured's shares that are subject to U.S. estate tax are increased by the proportionate amount of the death

Transfers made within three years of your death will still result in the death benefit being included in your worldwide estate.

benefit paid to the corporation.

The use of an ILIT may avoid these problems and provide protection against U.S. estate tax exposure for both U.S. and non-U.S. persons who are the life insured on the policy. When the death benefit is paid into the ILIT upon your death, it can be accessed to pay your estate taxes or other tax liabilities by having the ILIT loan the funds to your estate, or it can purchase your estate assets. The ILIT must be set up properly by a legal professional.

Contributions made by a U.S. citizen to the ILIT may be subject to U.S. gift tax or GSTT. However, you can make tax-free gifts up to the annual gift tax exclusion thresholds or use your lifetime gift tax exemption. In order to make gifts to a trust that qualify for the annual gift tax exclusion, the gifts have to provide the beneficiary with a "present interest" in the amount of the gift. Since a transfer to a trust provides a "future interest", the transfer will not qualify unless the trust provides the beneficiaries with the right to withdraw the funds contributed to the trust at the time of contribution. This right is referred to as a "Crummey Power". The Crummey Power can be limited to a period of time, such as 30 days. However, if limited, the amount of the annual exclusion would be reduced. A non-U.S. person can fund the ILIT with an unlimited amount of assets without incurring U.S. gift tax or GSTT (provided the assets gifted are not U.S. tangible assets).

If you already own a life insurance policy of which you are the insured, it is possible to transfer it to an ILIT, however, the transfer will be subject to the Canadian deemed disposition rules and potential U.S. gift or GSTT rules. Keep in mind that U.S. tax laws require that transfers made within three years of your death will still result in the death benefit being included in your worldwide estate.

Other issues to consider

For Canadian income tax purposes, the transfer of an existing life insurance policy to an ILIT will trigger a deemed disposition of the policy at FMV, which may result in taxation (the gains are treated as ordinary income). During the life of the insured, the 21-year deemed disposition rule does not apply to a life insurance policy owned by a trust.

Access to the cash surrender value and borrowing against the policy is not permitted. Therefore, an ILIT may not be appropriate if there is the potential that the policy will be required for investment or retirement purposes.

When a Canadian insurance policy is issued on the life of a U.S. citizen by a Canadian insurance provider, U.S. excise tax of 1% of the gross amount of the insurance premiums may need to be remitted to the U.S. Also, a Canadian insurance policy must meet the U.S. definition of a life insurance policy and must avoid the U.S. "modified endowment contract" rules and the "transfer for value" rules in order to be considered an exempt policy under U.S. income tax laws. A discussion of these rules is beyond the scope of this article.

You should contact a cross-border professional for advice on whether to incorporate the use of life insurance in your estate planning. They can help you understand the Canadian and U.S. tax implications and advise you on whether a reduction of your exposure to U.S. estate tax using an ILIT out-weighs the costs of setting one up and the annual fees associated with maintaining it.

Dynasty ILIT

It is possible to reduce yours and your heir's exposure to U.S. estate tax even further by structuring an ILIT as a Dynasty Trust. The features of the Dynasty ILIT reduce your own exposure to U.S. estate tax and protect the assets in the trust and their future growth from U.S. estate tax for your spouse, children, and successive generations.

Canadian testamentary spousal trust

A Canadian testamentary spousal trust is a special type of trust that can be established by a U.S. or non-U.S. citizen in Canada through their Will for the benefit of a surviving spouse. This type of spousal trust provides certain Canadian tax benefits and may be structured to protect your surviving spouse from U.S. estate tax.

When certain conditions outlined in the Canadian Income Tax Act are met, the Canadian tax benefits provided by a Canadian testamentary spousal trust includes the exemption from the deemed disposition tax rules that are normally triggered when assets are transferred to a trust. This allows a deferral of taxes on accrued capital gains on the assets transferred in and future growth until the assets are sold or the surviving spouse dies. Before 2016, testamentary trusts enjoyed additional tax benefits – namely taxation based on a graduated tax rate system. Currently, top marginal tax rates apply, subject to certain exceptions for disabled beneficiaries. Another benefit of this type of trust is the exemption from the 21-year deemed disposition rule that triggers taxation of accrued gains on assets held in a trust after 21 years of the trust's existence.

To be considered a Canadian testamentary spousal trust, the surviving spouse and the deceased spouse must both be Canadian residents immediately before death. Your surviving spouse must be the only beneficiary of the trust. All income earned in the trust during the surviving spouse's lifetime must be paid to the spouse but the capital may be preserved for successive beneficiaries (typically children or grandchildren). It is possible to allow the surviving spouse to draw on the capital under specific circumstances, which you can specify in your Will. If a testamentary spousal trust is set up as a U.S. trust (even if it is deemed to be a Canadian resident trust) it will not qualify as a Canadian testamentary spousal trust.

To protect the assets transferred to the trust, and future growth of these assets from U.S. estate tax, your spouse as a beneficiary should not be given a general power of appointment. Your spouse can be provided limited powers of appointment, a concept that was discussed earlier in the article. If you would like to provide your spouse with more flexibility, an independent trustee can be named who can approve additional capital distributions.

When your surviving spouse dies, their estate will be exempt from having to include the value of the assets of a Canadian testamentary spousal trust in determining their U.S. estate tax liability. However, it is important to consider whether the estate of the first spouse to die will be subject to U.S. estate tax as a result of transferring assets to the U.S. estate tax protected spousal trust. You may consider alternative planning that will avoid U.S. estate tax on the death of the first spouse at the expense of being able to structure the spousal trust with U.S. estate tax protection. This will avoid U.S. estate tax until the death of the second spouse.

We discussed earlier the estate planning for U.S. citizens creating CSTs that can qualify as a Canadian testamentary spousal trusts for a surviving U.S. or non-U.S. citizen spouse. Here we discuss the strategy for a non-U.S. person whose surviving spouse is a U.S. citizen.

When a non-U.S. person's surviving spouse is a U.S. citizen

A spouse who is a non-U.S. person who dies first may be subject to U.S. estate tax with respect to U.S. situs assets owned. However, the executor can claim an unlimited marital deduction by transferring the assets to your surviving U.S. citizen spouse outright or to a separate Canadian testamentary spousal trust that makes a QTIP election. However, when the surviving U.S. citizen spouse dies, the U.S. situs assets in the spousal trust that makes a QTIP election will be included in their worldwide estate and may be subject to U.S. estate tax. To allow the assets to transfer to the trust on a tax-deferred basis for Canadian tax purposes and to qualify for the QTIP election, only the surviving spouse can be a beneficiary of this trust.

If your estate has both U.S. situs and non-U.S. situs assets, it is recommended that your estate transfer the non-U.S. situs assets to a separate Canadian testamentary spousal trust. Since these assets are not subject to U.S. estate tax on the death of the non-U.S. citizen spouse, the trust is not required to make a QTIP election. As a result, the trust can be structured to provide U.S. estate tax protection for the surviving U.S. citizen's spouse. To allow the assets to transfer to this trust on a tax-deferred basis for Canadian tax purposes, only the surviving spouse can be a beneficiary of the trust.

Refer to Appendix 3 for an example of an estate plan for a non-U.S. citizen spouse using Canadian testamentary spousal trusts to reduce theirs and their surviving U.S. citizens spouse's exposure to U.S. estate tax.

A Canadian testamentary spousal trust may be useful where the intention is to have the income of the trust support the surviving spouse while they are alive but to preserve the capital of the trust for the benefit of children or grandchildren. To preserve the Canadian testamentary spousal trust status, the resulting Canadian tax benefits, and ability to

Charitable donations made during your lifetime or through your Will may reduce your exposure to U.S. estate tax as well as provide an income tax deduction.

make a QTIP election, children and grandchildren cannot be included as beneficiaries of this type of trust. The capital of the trust will pass to them once the surviving spouse is deceased. They may receive the capital outright or as beneficiaries of successive testamentary trusts on the death of your spouse.

If the successive beneficiaries (children and grandchildren) are U.S. citizens, testamentary Dynasty Trusts set up as U.S. trusts (or dual resident trusts, if the U.S. beneficiaries reside in Canada) may be more appropriate than setting up Canadian testamentary trusts. This is because U.S. beneficiaries of Canadian testamentary trusts may be subject to the adverse U.S. throw-back rules (discussed earlier) if income earned in the trust is not distributed annually. While making annual distributions of income earned in a trust set up as a Canadian testamentary trust will avoid these rules, it may result in distributions that are greater than what the beneficiaries are able to use up during their lifetime. This may expose unused distributions accumulated in the beneficiaries' estate to U.S. estate tax.

If you have beneficiaries living in the U.S. and you structure the Dynasty Trust be resident in the U.S., the 21-year deemed disposition rule can be avoided except for Canadian real property and business assets owned by the trust. If the beneficiaries are residents of Canada, the Dynasty Trust may be deemed to be a Canadian resident trust under the Canadian non-resident trust rules notwithstanding the fact that it may also be considered a U.S. resident under U.S. tax laws. These trusts would be subject to the 21-year deemed disposition rule. Whether the trust is resident in Canada or deemed resident in Canada, foreign tax credits may be claimed in Canada for U.S. income tax paid, which may minimize the possibility of double taxation.

If your wish is that your children and grandchildren benefit from your estate prior to the death of your surviving spouse, you could provide for them with separate distributions from your estate. These distributions can be made to them outright or to separate trusts, such as a Dynasty Trust discussed earlier. To minimize or avoid double tax, for Canadian tax purposes the tax on the accrued gains triggered can be minimized or offset with foreign tax credits for U.S. estate tax incurred by your estate.

Speak to a cross-border tax or legal professional regarding the appropriateness of using a Canadian testamentary spousal trust in your estate planning.

Charitable donations

Charitable donations made during your lifetime or through your Will may reduce your exposure to U.S. estate tax as well as provide an income tax deduction. As a U.S. citizen, you can make charitable gifts, which are not subject to U.S. gift tax, and reduce the amount of assets in your estate. You can also make charitable bequests, which can be deducted in calculating your U.S. estate tax liability. Your charitable gifts or bequests must be made to qualified U.S. or foreign charities. As a non-U.S. person, the same benefits may be achieved, except you must make gifts or bequests of U.S. situs assets only and the gifts or bequests can only be made to U.S. qualified charities.

For Canadian income tax purposes, a donation tax credit for gifts to U.S. qualified charities may only be claimed against U.S. source income. However, a donation credit for gifts made to a qualified university in the U.S. or to a U.S. charitable organization to which the Government of Canada has made a gift may be claimed against Canadian sources of income. Under the Treaty, contributions made by a U.S. citizen or resident to a Canadian

Estate planning for U.S. citizens in Canada must take into consideration both Canadian and U.S. tax and estate laws.

registered charity qualify as charitable contributions for U.S. income tax purposes. However, the charitable tax deduction available on your U.S. income tax return is subject to two restrictions. First, a U.S. donor may use the deduction only against their Canadian source income. Second, the deduction is subject to percentage limitations. The percentage limitations permit a U.S. donor that made charitable contributions to a Canadian registered charity classified as a private foundation to deduct up to 30% of the donor's income derived from Canada. Any excess may be carried over and deducted in subsequent taxable years. This percentage amount is raised to 50% if the Canadian registered charity is classified as a non-private foundation.

Speak to a tax advisor for advice regarding implementing a charitable giving strategy for estate planning and income tax purposes.

Foreign Account Tax Compliance Act (FATCA)

If you are a U.S. citizen in Canada, you face a significant compliance burden. When you consider planning for your Canadian and U.S. estate needs, you may use non-U.S. based entities such as Canadian trusts which may increase your U.S. reporting obligations. The U.S. enacted FATCA to improve tax compliance involving foreign financial assets and offshore accounts. Under FATCA, U.S. taxpayers living in Canada may be required to report ownership of foreign assets to the Internal Revenue Service. In addition, FATCA will require foreign financial institutions to report information to the Canada Revenue Agency related to certain financial accounts held by U.S. taxpayers, or held by foreign entities in which U.S. taxpayers hold a substantial ownership interest. Speak to a cross-border tax or legal advisor to discuss the reporting obligations that may result from owning foreign assets or including non-U.S. trusts in your estate planning.

Planning for the future

Estate planning for U.S. citizens in Canada must take into consideration both Canadian and U.S. tax and estate laws. When some of your family members are not U.S. citizens, the planning is more complex. This article has presented some of the common cross-border estate planning strategies that may be considered in reducing yours and your beneficiary's exposure to U.S. estate tax. If President Trump is successful in the repeal of U.S. estate tax, keep in mind that it can be reinstituted again at some point in the future. Therefore, your estate plan should be flexible so that changes can be made as necessary.

Be sure to consult with a cross-border tax or legal professional to discuss the appropriateness of any of these strategies in meeting your estate planning needs.

Appendix 1 – Both spouses are U.S. citizens

Example of an estate plan for U.S. citizen spouses to minimize U.S. estate tax. This example is based on the U.S. estate tax exemption of US$5.49 million for 2017.

Each spouse's Will contains identical provisions that provide for the creation of a Credit Shelter Trust (CST) and a spousal trust. Each of the trusts are structured to qualify as Canadian testamentary spousal trusts. Therefore, your spouse must be the only beneficiary of the trust during their lifetime.

On the death of the first spouse, the first US$5.49 million of assets in their estate is transferred to a CST. The estate of the first spouse cannot claim the unlimited marital deduction for the assets transferred to the CST because the assets in the CST and any future growth of those assets are protected from U.S. estate tax on the surviving spouse's death. However, the estate of the first spouse avoids U.S. estate tax by claiming their U.S. estate tax exemption.

The remaining assets in the estate of the first spouse to die are transferred to the surviving spouse directly or to a spousal trust. The estate of the first spouse to die can claim the unlimited marital deduction for the transfer of assets directly to the surviving spouse. It can also claim the unlimited marital deduction for assets transferred to a spousal trust if a Qualified Terminal Interest Property (QTIP) election is made. The assets in the spousal trust with a QTIP election are not protected from U.S. estate tax. Therefore, when the surviving spouse dies, the assets in the spousal trust are subject to U.S. estate tax.

For Canadian tax purposes, the transfer of assets to the CST and to the spousal trust that both qualify as Canadian testamentary spousal trusts is tax-deferred and occurs at their adjusted cost basis. This avoids the deemed disposition tax rule that would otherwise trigger Canadian capital gains tax on accrued gains. During the surviving spouse's lifetime, the 21-year deemed disposition rule, which also triggers accrued gains on assets held in these trusts every 21 years, does not apply.

Children and grandchildren can be provided for with successive trusts created upon the death of the surviving spouse.

On death of 1st U.S. citizen spouse

First US$5.49 million

CST

U.S. estate tax protection for beneficiary

- No U.S. estate tax on 1st US$5.49 million of assets transferred to CST since U.S. estate tax exemption is claimed
- Canadian capital gains tax deferred and 21-year deemed disposition avoided if CST structured as a Canadian testamentary spousal trust

Excess over US$5.49 million

Directly to spouse or to spousal trust with QTIP election

No U.S. estate tax protection for beneficiary

- No U.S. estate tax on assets transferred due to unlimited marital deduction allowed with the QTIP
- Canadian capital gains tax deferred and 21-year deemed disposition avoided if transferred directly or the trust structured as a Canadian testamentary spousal trust

On death of surviving U.S. citizen spouse

- Assets in trust protected from U.S. estate tax on death of surviving spouse
- Canadian capital gains tax on accrued gains

- Assets held directly or in spousal trust with QTIP are not protected from U.S. estate tax on death of surviving spouse
- Canadian capital gains tax on accrued gains

Note: If your wish is that your children and grandchildren benefit from your estate prior to the death of your surviving spouse, you could provide for them with separate distributions from your estate. These distributions can be made to them outright or to separate trusts (e.g. Dynasty Trusts). Your estate may be subject to U.S. estate tax. For Canadian tax purposes the tax on the accrued gains triggered can be minimized or offset by claiming foreign tax credits for U.S. estate tax incurred. The adjusted cost basis of the assets transferred is bumped up to its fair market value thus reducing the capital gain triggered when the assets are sold.

Appendix 2 – One spouse is a U.S. citizen who dies first

Example of an estate plan to minimize U.S. estate tax in the case of a U.S. citizen spouse who is survived by a non-U.S. citizen spouse. This example is based on the U.S. estate tax exemption of US$5.49 million for 2017.

The U.S. citizen's Will includes provisions that provide flexibility to create a Credit Shelter Trust (CST), a spousal trust and a Qualified Domestic Trust (QDOT).

Upon the U.S. citizen's death, the first US$5.49 million of assets of their estate is transferred to a CST for the benefit of their surviving spouse. The estate may not claim the marital credit under the Canada-U.S. Tax Treaty (Treaty) for assets transferred to the CST. However, since only the value up to their estate tax exemption is transferred to this trust, the deceased's estate can claim their U.S. estate tax exemption to avoid U.S. estate on these assets. These assets and future growth are protected from U.S. estate tax. Therefore, when the non-U.S. citizen surviving spouse dies, there will be no U.S. estate tax on assets in the CST. Since the surviving non-U.S. citizen spouse is subject to U.S. estate tax on U.S. situs assets only, consider transferring U.S. situs assets to the CST before other types of assets.

The remaining assets in the estate of the U.S. citizen spouse may be transferred to the surviving non-U.S. citizen spouse directly or to a spousal trust. The Treaty allows the estate to claim a martial credit for the transfer of assets directly or to the spousal trust. Based on the 2017 estate tax rates, the maximum marital credit that can be claimed will eliminate U.S. estate tax on the next US$5.35 million worth of assets. This value is calculated based on the maximum 2017 U.S. unified credit (US$2,141,800) divided by the maximum U.S. estate tax rate (40%).

The estate is not required to make a Qualified Terminal Interest Property (QTIP) election to claim the marital credit for assets transferred to the spousal trust for a Canadian resident spouse. Therefore, the spousal trust can be structured to protect assets in the trust from exposure to U.S. estate tax that would otherwise be triggered on the surviving spouse's death. If structured properly, when the surviving non-U.S. citizen spouse dies, there will be no U.S. estate tax on U.S. situs assets in the trust.

If the value of the assets transferred to the spousal trust exceeds US$5.35 million, U.S. estate tax will apply on the excess value. In lieu of claiming the marital credit, the estate may decide to transfer the assets to a Qualified Domestic Trust (QDOT) for the benefit of the surviving non-U.S. citizen spouse. The estate can claim an unlimited marital deduction instead of the marital credit. The unlimited marital deduction provides the estate of the U.S. citizen spouse a deferral not a credit against U.S. estate tax. The deferral lasts until the surviving non-U.S. citizen spouse dies or distributions of capital are made from the QDOT. Upon the death of the surviving non-U.S. citizen spouse, the value of the assets in the QDOT (assets transferred in and growth) will be subject to U.S. estate tax at the tax rates that existed in the year the U.S. citizen spouse died.

The estate must choose between claiming the marital credit or implementing the QDOT to claim the unlimited marital deduction, it cannot claim both. Since the use of the QDOT provides only a deferral of U.S. estate tax for the U.S. citizen spouse, this strategy may only be considered in cases where the value of the excess assets is significantly greater than US$5.35 million and the U.S. estate tax liability is significant. In order for the trust to qualify as a QDOT only the surviving spouse may be a beneficiary of the QDOT.

For Canadian tax purposes, the transfer of assets to the CST, the spousal trust or the QDOT that qualifies as a Canadian testamentary spousal trust is tax-free and occurs at their adjusted cost basis. To qualify for this treatment only the surviving spouse may be a beneficiary of this trust during their lifetime. This avoids the deemed disposition tax rules that would otherwise trigger Canadian capital gains tax on accrued gains. During the surviving spouse's lifetime, the 21-year deemed disposition rule, which also triggers accrued gains on assets held in these trusts every 21 years, does not apply.

Children and grandchildren can be provided for with successive trusts created upon the death of the surviving spouse from the capital of these trusts.

On death of 1st spouse, the U.S. citizen spouse

First US$5.49 million

CST

U.S. estate tax protection for beneficiary

- No U.S. estate tax on 1st US$5.49 million transferred to CST since U.S. estate tax exemption is claimed
- Canadian capital gains tax deferred and 21-year deemed disposition avoided if CST is structured as a Canadian testamentary spousal trust

Excess over US$5.49 million

Directly to spouse or to spousal

U.S. estate tax protection for the beneficiary on assets in spousal trust

- No U.S. estate tax on next US$5.35 million of assets transferred to surviving spouse or spousal trust by claiming marital credit and no QTIP election is required by the trust
- Canadian capital gains tax deferred and 21-year deemed disposition avoided if the spousal trust is structured as a Canadian testamentary spousal trust

OR

QDOT

U.S. estate tax deferral for the former spouse

- If the value of the excess is significantly greater than US$5.35 million consider deferring U.S. estate tax by transferring the excess assets to a QDOT and claiming the unlimited marital deduction instead of the marital credit
- Canadian capital gain tax deferred and 21-year deemed disposition avoided if QDOT is structured as a Canadian testamentary spousal trust

On death of surviving non-U.S. citizen spouse

- Canadian capital gains tax on accrued gains
- Assets in the CST are protected from U.S. estate tax

- Canadian capital gains tax on accrued gains
- U.S. estate tax may apply on U.S. situs assets held directly
- US situs assets in the spousal trust are protected from U.S. estate tax

- Canadian capital gains tax on accrued gains
- Deferral of U.S. estate tax of former spouse ends
- Value of assets in the QDOT subject to U.S. estate tax based on estate tax rates in the year the former spouse died

Note: If your wish is that your children and grandchildren benefit from your estate prior to the death of your surviving spouse, you could provide for them with separate distributions from your estate. These distributions can be made to them outright or to separate trusts (e.g. Dynasty Trusts). Your estate may be subject to U.S. estate tax. For Canadian tax purposes the tax on the accrued gains triggered can be minimized or offset by claiming foreign tax credits for U.S. estate tax incurred. The adjusted cost basis of the assets transferred is bumped up to its fair market value thus reducing the capital gain triggered when the assets are sold.

Appendix 3 – One spouse is a U.S. citizen who dies last

Example of an estate plan to minimize U.S. estate tax in the case of a spouse who is a non-U.S. person who is survived by a U.S. citizen spouse. This example is based on the U.S. estate tax exemption of US$5.49 million for 2017.

Since a non-U.S. citizen spouse may own both U.S. and non-U.S. situs assets, their estate plan could include provisions in their Will that allow for the creation of two Canadian testamentary spousal trusts for the benefit of their surviving U.S. citizen spouse.

One of the trusts may be used to transfer in U.S. situs assets only. In order to claim the unlimited marital deduction avoiding U.S. estate tax on the first death, the estate of the non-U.S. citizen spouse must either transfer the U.S. situs assets to the surviving U.S. citizen spouse directly or transfer them to the trust that makes a Qualified Terminal Interest Property (QTIP) election. Assets held directly or through a trust with a QTIP election are not protected from U.S. estate tax. Therefore, on the death of the surviving U.S. citizen spouse, the assets are included in the U.S. citizen spouse's taxable estate for U.S. estate tax purposes.

A non-U.S. person is not subject to U.S. estate tax on non-U.S. situs assets. Therefore, these assets can be transferred to another trust where a QTIP election is not needed as there is no need to claim the unlimited marital deduction. It is possible to structure this trust to protect the assets transferred in and future growth from U.S. estate. Therefore, on the death of your surviving spouse, the assets in this trust will not be included in their estate for U.S. estate tax purposes.

For Canadian tax purposes, since both trusts are Canadian testamentary spousal trusts, the transfer of assets to the trust is tax-free and occurs at their adjusted cost basis. To qualify for this treatment the surviving spouse can be the only beneficiary of the trust during their lifetime. This type of trust avoids the deemed disposition tax rules that would otherwise trigger Canadian capital gains tax on accrued gains. During the surviving spouse's lifetime, the 21-year deemed disposition rule, which also triggers accrued gains on assets held in these trusts every 21 years, does not apply.

Children and grandchildren can be provided for with successive trusts created upon the death of the surviving spouse with the capital from these trusts.

On death of 1st spouse, the non-U.S. citizen spouse

Non-U.S. situs assets

Canadian testamentary spousal trust structured for U.S. estate tax protection

U.S. estate tax protection for the beneficiary

- Transfer of assets on tax-free rollover basis for Canadian tax purposes - Canadian capital gains are tax deferred and Canadian 21-year deemed disposition avoided
- No U.S. estate tax since no U.S situs assets are transferred in

U.S. situs assets

Directly to spouse or to separate Canadian testamentary spousal trust with QTIP election

No U.S. estate tax protection for beneficiary of trust with QTIP election

- Transfer of assets on tax-free rollover basis for Canadian tax purposes - Canadian capital gains are tax deferred and Canadian 21-year deemed disposition avoided
- No U.S. estate tax on U.S. situs assets transferred in to trust with QTIP election (i.e. may claim the unlimited marital deduction)

On death of surviving U.S citizen spouse

Non-U.S. situs assets:

- Canadian capital gains tax on accrued gains
- Assets in a spousal trust structured to be U.S. estate tax protected are not subject to U.S. estate tax

U.S. situs assets:

- Canadian capital gains tax on accrued gains
- Assets in spousal trust with QTIP are not protected from U.S. estate tax

Note: If your wish is that your children and grandchildren benefit from your estate prior to the death of your surviving spouse, you could provide for them with separate distributions from your estate. These distributions can be made to them outright or to separate trusts (e.g. Dynasty Trusts). Your estate may be subject to U.S. estate tax. For Canadian tax purposes the tax on the accrued gains triggered can be minimized or offset by claiming foreign tax credits for U.S. estate tax incurred. The adjusted cost basis of the assets transferred is bumped up to its fair market value thus reducing the capital gain triggered when the assets are sold.

Please contact us for more information about the topics discussed in this article.