CROSS-BORDER ESTATE PLANNING BASICS

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Canadian residents who acquire property located or deemed to be located in the United States are subject to potential U.S. estate tax on the value of that property owned at death. Among types of property deemed to be located in the United States are U.S. real estate, stock in U.S. corporations (including most U.S. mutual funds), debt obligations of U.S. issuers or persons (where, with some exceptions, debt can include almost any kind of contractual right, such as a stock option or pension), and cash on deposit in U.S. financial institutions other than banks. While the details of drafting and implementation of a cross-border estate plan are beyond the scope of this article, the following discussion highlights the major issues.

For a married couple, the basic principle of estate planning (on both sides of the border) is to defer death taxes during the life of the surviving spouse. A second basic principle for those subject to U.S. estate tax is to avoid wasting the exemption available on the first death. The exemption presently is $1.5 million per person and is scheduled to increase to $2 million in 2006. To see how these principles interact, consider a married couple, both U.S. citizens, each with an estate of $1.5 million.

The first spouse to die can defer both U.S. estate tax and Canadian gains tax by leaving everything to the survivor, but this simplicity has a heavy cost—about $700,000 of entirely avoidable tax—because the surviving spouse now has an estate of $3 million, but only a $1.5 million exemption. The remedy is to leave the exemption amount in trust, rather than outright. If the estate of the first to die exceeds the exemption equivalent, estate tax can be deferred by leaving the excess for the surviving spouse's benefit in a form that qualifies for the marital deduction.

If the first spouse to die is a Canadian resident and the surviving spouse is a U.S. citizen, an outright gift qualifies, as does a gift in a trust that meets the requirements for the Canadian spousal rollover. If the spouse is not a U.S. citizen, however, there are two alternatives. The tax treaty between Canada and the United States allows a marital credit equal to the amount of the available exemption for assets left to a spouse who is not a U.S. citizen. Thus a U.S. citizen with a non-citizen spouse and a $3 million estate could leave his or her entire estate to the spouse outright and without U.S. estate tax ($1.5 million exemption, plus a $1.5 million marital credit). However, if the U.S. citizen's estate is worth more than twice the exemption amount, the estate tax can only be deferred through a marital trust that meets the burdensome requirements of a qualified domestic trust (commonly referred to as a

QDOT).

A Canadian citizen with a U.S. citizen spouse can defer Canadian tax and entirely avoid U.S. estate tax through a spousal trust as long as its terms do not expose the trust to U.S. estate tax on the spouse's death. A Canadian citizen has an exemption of only $60,000, but the treaty allows as an alternative a pro-rated exemption equal to the exemption available to a U.S. citizen multiplied by the ratio that the Canadian citizen's U.S. property bears to his or her worldwide property.

Under the treaty, therefore, a Canadian resident with a worldwide gross estate of less than U.S. $1.5 million would not owe any U.S. estate tax. Even a much wealthier Canadian resident may avoid U.S. estate tax if the numbers fall in the right places. Consider, for example, a Canadian resident who has a U.S. spouse and dies with an estate of U.S. $3 million, of which U.S. $1 million is in U.S. real estate. Under the treaty, the Canadian resident's estate is entitled to a pro-rated exemption of $500,000 ($1.5 million times one-third). In addition, he or she is entitled to a marital credit of the same amount. The total ($1 million) completely shelters the U.S. real estate from U.S. estate tax.

If the Canadian resident's estate were $5 million, only $600,000 would be sheltered ($1.5 million times one-fifth, times two), leaving $400,000 of U.S. assets exposed to tax. Unless the surviving spouse were terminally ill, the optimal plan is probably to defer all taxes by leaving $600,000 to the U.S. spouse, either outright or in a spousal trust that qualifies for the U.S. marital deduction, and the balance of the estate ($4.4 million) in a trust that is not subject to U.S. estate tax on the U.S. spouse's death. If the U.S. spouse has an estate of $1 million, this plan would completely avoid U.S. estate tax. While estate tax on the first death could also be avoided by leaving everything to the U.S. spouse, the estate tax in that case would be close to $3 million.

Planning for cross-border issues is not limited to U.S. issues and it is important to involve both U.S. and Canadian counsel. The rules can be complex, but proper professional planning may result in substantial tax savings.