Cross-Border Canadian-U.S. Planning

By

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CANADA AND THE UNITED STATES have been each other's largest trading partners. Along with this extensive flow of goods has been a substantial migration of people. Canadians come to the United States to go to school, to work, to invest, to visit, and to retire. Similarly, Americans move to Canada to work and provide services, to invest and to purchase vacation homes, as well as to visit. The moves may be temporary or permanent. Clearly our societies have grown more and more mobile and that trend may be expected to continue to grow.

This mobility does create substantial tax and estate planning issues, and this article provides some background to those issues and discusses numerous alternatives in a variety of estate planning settings. It begins with a summary of Canadian tax law, which is done without citation. Although my Firm has an extensive cross-border practice, it is limited to U.S. law. By providing this summary I do not to suggest that we do practice Canadian law. The summary comes from my experience with working with numerous Canadian professionals and significant portions are derived from a paper presented at the ACTEC Summer 2004 Meeting by Leopold Amighetti, Q.C., and Darrell J. Wickstrom, his partner in the Vancouver office of Fasken Martineau DuMoulin LLP. The brief bibliography (in the Appendix) also directs the reader to publications that can provide a more technical analysis.

AN AMERICAN'S SUMMARY OF THE CANADIAN TAX SYSTEM ♦ Canada imposes its federal income tax on resident individuals, estates, trusts, and corporations. Generally, an individual is a resident in Canada for income tax purposes either because he or she was in Canada for greater than 182 days in any calendar year (subject to Treaty relief), or meets the equivalent of a domicile test, regardless of how many days he or she was in Canada in that year. Tax on individuals is imposed at varying marginal rates. There is a basic personal exemption amount on which no income tax is imposed.

Capital gains are taxed in Canada by applying the income tax rates only to a portion of the gain. Currently, an amount equal to 50 percent of the gain earned on the disposition of capital property over its "adjusted cost basis" is included in the taxpayer's income. Certain capital assets, such as personal residences, are exempt from tax, and many forms of corporate reorganizations may be done on a tax-free basis.

Transfers of capital property, whether or not for consideration, are recognition events. This includes all capital assets owned by a decedent at death. There is, however, no gift, estate, or other inheritance tax.

The Canadian provinces and territories apply a separate income tax, essentially as a surcharge to the federal income tax, at rates and with regard to tax brackets which vary from province to province. The tax is calculated on the federal form and the federal government acts as the collection agency on behalf of the provinces and territories. Quebec, however, has developed its own independent provincial tax system, requiring separate returns and separate payments.

As noted above, each deceased taxpayer is deemed to have disposed of his or her own capital property for proceeds equal to the fair market value of such a property immediately before death. This disposition includes the recognition of all accrued items of income, such as Canadian deferred compensation arrangements (RRSPs, retirement income funds, pension funds, and the like). This income is reported on the deceased taxpayer's final, or terminal, return.

The primary exception to the general rule of taxation at death is the tax-exempt rollover of property that passes to the deceased taxpayer's spouse (which includes all "common-law partners" of different or same sex.) This same rollover treatment is available for assets passing to a qualifying "spouse trust." The rules for a spouse trust are essentially identical to those for a trust that is eligible for the U.S. estate tax marital deduction. Other exemptions are available for certain qualifying farm property.

Note that a non-resident of Canada who dies owning Canadian situs property (most typically, Canadian real property) will be subject to tax on the taxable gain calculated with respect to that property. Canada also imposes an exit or departure tax on any taxpayer who ceases to be a Canadian resident. The effect is similar to that at death (although Treaty relief may be available with respect to retirement plans.)

Income earned by inter vivos trusts is taxed at the highest federal marginal rate if it is a Canadian resident trust. As with individuals, provincial tax is then added to the federal tax to arrive at the total tax payable. Trusts are entitled to deduct from their income, however, any amount of income which has been paid during the year to the beneficiaries of the trust. Trusts may not be used, however, to avoid the deemed dispositions at death. A Canadian trust (or a trust holding Canadian situs property) is deemed to have disposed of its assets (or Canadian assets) at the assets' fair market value every 21 years from the date of the creation of the trust. Note that trusts which are residents of Canada are permitted to avoid the application of the rule if the trust assets are distributed to Canadian resident beneficiaries (in which case the beneficiaries would receive a carryover tax basis in that property).

EFFECT OF THE TREATY ON THE U.S. ESTATE TAX SYSTEM WITH RESPECT TO CANADIAN DECEDENTS AND THEIR ESTATES ♦ Although Canada has no estate tax and, therefore, no separate estate tax Treaty with the United States, the Canada-U.S. Income Tax Treaty includes provisions for the application of the U.S. estate tax to estates of Canadian citizens who are not U.S. residents at death as well as to U.S. citizens who are residents of Canada or own Canadian situs assets at death.

Charitable Deductions

Generally, charitable transfers by a non-U.S. citizen/resident to non-U.S. charities do not qualify for the charitable deduction from U.S. estate tax. Rather than being limited to U.S. charities, the Protocol expands qualified charities to include all Canadian-registered charities so that the estate of a Canadian citizen is entitled to an unlimited charitable deduction under Internal Revenue Code

("Code") section 2106(a)(2), as long as the transferred property is subject to the U.S. estate tax. Protocol, art. XXIX B, par. 1. (All section references are to the Code unless otherwise indicated.)

Credits

A number of valuable credits are available to decedents in these circumstances.

Foreign Death Tax Credit

The Canadian capital gains tax on deemed dispositions at death is now treated as a foreign death tax credit, rather than merely a deduction. Protocol, art. XXIX B, par. 7. Thus, for example, the estate of a U.S. citizen who is not a resident of Canada, but who owns Canadian real estate, will pay the Canadian capital gains taxes to Canada, but then may use such payment as a foreign death tax eligible for a credit under section 2014. Moreover, the IRS has agreed to adhere to a competent authority ruling that the Canadian income tax payable with respect to accrued ordinary income items, such as Canadian retirement plans, is eligible for foreign tax credit treatment.

Similarly, the U.S. estate taxes imposed on a Canadian decedent's U.S. situs asset (such as an Arizona condominium) may be used as a foreign tax credit against the Canadian federal income tax liability associated with such asset (such as the deemed disposition capital gains tax). Protocol, art. XXIX B, par. 6.

Pro-Rated Unified Credit

Under the Protocol, the estate of a non-U.S. citizen/resident is eligible for an expanded estate tax credit (the "pro-rated credit"). The prorated credit is determined by multiplying the applicable estate tax credit by a fraction, the numerator of which is the value of the U.S. situs assets and the denominator of which is the value of the worldwide assets. Contrast the prorated credit with the otherwise maximum estate tax credit under the Code of $13,000 on the estate of a non-U.S. citizen/resident (which has the effect of sheltering only $60,000 of U.S. situs assets from estate taxes). The pro-rated credit has the effect of completely eliminating U.S. estate tax on the estate of a Canadian whose worldwide estate is less than the applicable exclusion amount ($1.5 million in 2004).

Marital Credit

The Protocol permits a marital credit, in lieu of a marital deduction, on transfers at death to a surviving spouse equal to the allowable estate tax credit when, at the time of death:

- The decedent was a citizen of the United States or a resident of either Canada or the United States;
- The surviving spouse at the time of the decedent spouse's death was a resident of either Canada or the United States;
- Both were U.S. residents at the time of decedent spouse's death, and at least one was a Canadian citizen; and
- The executor of the decedent's spouse's estate elects the benefits of the Protocol and irrevocably waives the benefits of the estate tax marital deduction. Protocol, art. XXXIX B, par 3.

For example, assume a married couple are both Canadian citizens and residents, and one dies owning U.S. situs property (such as a Florida condominium). The estate would be eligible to elect to take the Protocol marital credit, essentially resulting in a doubling of the applicable estate tax credit, if the estate passes to the surviving spouse in a way that would qualify for the marital deduction if the surviving spouse were a U.S. citizen (even, in this case, by an outright transfer). However, it is important to note that if the Protocol marital credit is elected, the QDOT marital deduction under U.S. domestic estate tax law is not available, even if an otherwise qualifying trust were created. In short, an executor must choose between two options.

ESTATE PLANNING FOR U.S. CITIZENS MOVING TO CANADA ♦ Moving to Canada simply adds tax problems for a U.S. citizen because U.S. citizens must report worldwide income (no matter where they reside) and because they are subject to the U.S. transfer tax system on their gratuitous transfers of all property, wherever situated, during life and on death (no matter where they reside). Upon becoming a Canadian resident for Canadian tax purposes, the U.S. citizen reports worldwide income to two countries. There are, of course, differences in what income is reported and what deductions are available. Nonetheless, there is a considerable overlap of net taxable worldwide income. Both the Code and the Canada-U.S. Tax Treaty provide some relief from double taxation during life. Canada-United States Income Tax Convention, T.I.A.S. No. 11087, 1469 U.N.T.S. 189. (This Treaty was entered into force August 16, 1984, and generally was effective January 1, 1985. The Treaty has been revised four times to date. The Third Protocol to the Convention, which was entered into force November 9, 1995, is perhaps the most important with respect to cross-border estate planning because it added Article XXIX B governing taxes at death.)

Two examples of benefits accorded under the Code to reduce double taxation during life are: (1) the first $80,000 of foreign earned income, as adjusted for inflation, may be elected to be excluded from gross income; §911(a)(1) and (b)(2); and (2) Canadian income tax may be claimed as a foreign tax credit, subject to the complex limitations of the foreign tax credit rules. §27. Under current tax law for years before 2005, however, for alternative minimum tax purposes a maximum of 90 percent of the regular alternative minimum tax is permitted to be used as a foreign tax credit. §59(a)(2). As a consequence of this limitation, most middle- to high-income U.S. citizens resident in Canada not only must pay the high rates of Canadian federal and provincial income tax, but also must pay the United States an alternative minimum tax with respect to the same income items that may run as high as 3.5 percent.

Examples of benefits available under the Treaty include the right to defer reporting earnings from Canadian qualified deferred compensation plans. Note, however, that the actual deferral of compensation to such plans does not yield a deduction or exclusion for U.S. income tax purposes. Deferring the earnings in such plans is important, nonetheless, so that the recognition of the income upon ultimate distribution is taxed at the same time to the same taxpayer, thereby enabling the fullest use of the foreign tax credit. It should also be noted that such deferrals need to be elected with respect to U.S. plans, including IRAs, on the Canadian returns.

For purposes of measuring gain or loss for Canadian capital gains purposes, a U.S. citizen who moves to Canada starts with a tax cost basis of the fair market value of each asset determined on the first day of Canadian residence, for Canadian income tax purposes. (Canada also has a departure or "exit" tax which in effect treats all accrued income as taxable on the date of departure.)

Taxes On Death

Canada repealed its federal estate and gift taxes as of the end of 1971. The provinces followed thereafter. Accordingly, at the present time there are no federal or provincial estate, inheritance, or death taxes.

At the same time, however, as noted above, a deceased Canadian resident is deemed to have all of the accrued income items realized and recognized as of the year of death and reported on a terminal personal income tax return (with some exceptions). Therefore, the estate of a U.S. citizen who dies a resident of Canada faces potentially three levels of taxes: U.S. estate taxes on her or his worldwide estate; Canadian capital gains taxes arising from the deemed disposition of all capital assets; and U.S. and Canadian income taxes payable with respect to deferred compensation, retirement plans and annuities, and similar contractual rights. Note the further problem of the last category of income being reported by different taxpayers at different times: for Canadian income tax purposes, the income is reported on the terminal return of the decedent, but for U.S. income tax purposes the income is only reported by the person receiving the distribution at the time of receipt.

Before the amendment of the Canada-U.S. Tax Treaty in 1995, the basic double taxation at death problem was only ameliorated by using the Canadian income tax liability on the terminal return as a deduction for U.S. estate tax purposes. The Third Protocol to the Treaty, however, has changed that. The Treaty benefits guide the design of the estate plan not only for U.S. citizens resident in Canada but also for Canadians with U.S. situs assets and for U.S. citizens married to Canadians with property in either jurisdiction.

Pre-Canadian Immigration Trusts

A U.S. citizen moving to Canada may avoid Canadian taxation on his or her investment income for the first five years of residence in Canada, provided that the investment assets are held in a qualifying immigration trust. The trust must not be a Canadian resident trust, which means that the trustees and the administration of the trust should remain in the United States. Clearly irrevocable U.S. trusts will work, and I have recently learned that because of draft Canadian tax legislation, a U.S. revocable trust may be effective for these purposes. In any event, if the trust is irrevocable, it is clear that the U.S. grantor should ensure that the terms of the trust are such that it would be an incomplete gift. Of course, one way to accomplish this is for the grantor to retain a power of appointment over the trust assets. There need not be any ascertainable standard or any significant limitations on invasion of the trust, so it would be typical for the trust to terminate and the assets to be distributed to the grantor or the grantor's spouse once the Canadian income tax advantage of the trust ends.

Revoke The Revocable Trusts

Notwithstanding the possibility of being able to use a U.S. revocable trust as a Canadian immigration trust, as discussed in the preceding section, it is generally advisable for U.S. citizens moving to Canada to revoke and distribute out the assets of their revocable trust and do their estate planning by Will. First of all, any additional contributions to such a trust once an individual becomes a Canadian income tax resident are deemed dispositions of the property, giving rise to the recognition of Canadian capital gains tax, even though it is not a tax event for U.S. income tax purposes. Moreover, it is possible that a Canadian probate court would not recognize a pour-over disposition from the Will that accompanies a revocable trust under the principle that the revocable trust may not have been executed with the formalities required for a testamentary instrument. Finally, there is a risk that because the trust would be a taxpayer separate from the decedent in Canada, the foreign death tax credit provisions of the Treaty may not be available.

ESTATE PLANNING FOR CANADIANS (OR MEMBERS OF CANADIAN FAMILIES) MOVING TO (OR LIVING IN) THE UNITED STATES, OR BUYING U.S. PROPERTY ♦ Perhaps a more common cross-border client situation for most U.S. trust and estate practitioners may be the representation of a client who has ties to Canada, either as a Canadian temporarily residing in the United States, or as a former Canadian who retains property interests situated in Canada (including as a shareholder in a Canadian corporation and a beneficiary of a Canadian trust).

Issues For U.S. Immigrants

If the clients are non-U.S. citizens, then it must be determined whether they are U.S. domiciliaries in order to know what gift and estate tax exemptions are available. Married couples need to consider use of qualified domestic trust provisions or marital credit benefits under the Treaty.

From an income tax perspective, an assessment must be completed of the immigrants' exposure to the corporate and trust anti-deferral rules. That assessment can be extremely labor intensive. To fail to do so may not only result in precluding the Canadian immigrant from making useful elections but also it may result in the imposition of significant penalties for failure to conduct proper compliance and reporting. If the analysis is completed before immigrating to the United States, it may well be possible to avoid the problems associated with these complex rules, or at a minimum, manage them so that there is no double taxation nor any penalties or interest.

Methods For Canadian NRAs To Hold U.S. Situs Assets

Canadian non-resident aliens ("NRAs") are subject to U.S. estate tax on their "U.S. situs assets," which are included in their estates as determined for U.S. estate tax purposes. Interests in U.S. real property as well as tangible personal property located in the United States are U.S. situs assets for gift and estate tax purposes. U.S. stocks and debts of U.S. persons are additional U.S. situs assets for estate tax purposes.

The following summarizes the issues arising under a variety of ownership options.

Wholly Owned By An Individual

Individually owned U.S. real estate does have several advantages and may be appropriate even with respect to U.S. estate tax planning. The lowest U.S. income tax rates are available; if one holds property for at least one year capital gains will be taxed at a maximum of 15 percent on the federal level. If the property generates taxable U.S. income, U.S. graduated rates are available if the income is connected to an active trade or business. In either case, the taxable events and taxpayers are coordinated so that the foreign tax credit should be available on the Canadian income tax return for the individual.

Although the properties are exposed to U.S. estate tax liability, that liability may be managed in a number of ways. First of all, if the individual's worldwide assets do not exceed the U.S. estate tax exemption, then there would be no U.S. estate tax due to application of the pro-rated exemption. The use of the marital credit may help to reduce U.S. estate tax exposure as well. Even if there is a U.S. estate tax, however, it is creditable against the Canadian capital gains tax on the deemed disposition at death, so the real test is not to totally avoid U.S. estate tax but to keep it within the projected Canadian capital gains tax. If, after taking into account the benefits of the foreign tax credit, there remains substantial exposure to U.S. estate tax, then either the marital deduction may be used if the individual is survived by his or her spouse, or a non-recourse mortgage loan can be taken on the property. The advantage of a non-recourse mortgage is that the debt reduces the value of the U.S. real property on a dollar-for-dollar basis, thereby reducing the taxable estate. The amount of the mortgage can be calibrated to reduce the effective amount of the U.S. estate tax to zero (again, taking into account the foreign tax credit benefit.)

Some non-tax benefits are that the property remains freely disposable by the individual and his or her Will may govern its disposition. It is my experience that Canadian Wills may be admitted for ancillary probate in virtually every U.S. State without much difficulty.

Tenancy-In-Common

Holding an interest as a tenant-in-common has the same basic features of the individually owned asset with the transfer tax benefit arising from the principle that an undivided fractional interest is entitled to a valuation discount. Of course, holding an interest in real property as a tenant-in-common may give rise to operational problems. (There is a good reason why valuation discounts are appropriate!) Nonetheless, when the other owners of the tenancy-in-common are family members, this type of ownership may be the simplest way of managing the U.S. estate tax liability.

Joint Tenancy

Joint tenancies among persons who are not U.S. citizen spouses create a serious problem under the U.S. estate tax rules. First, the party who dies first is presumed to have contributed the entire amount to the purchase of the property and, accordingly, 100 percent of the value is presumed included in that person's estate. It is the duty of the executor to carry the burden of proof to overcome such a presumption, and many times such proof is difficult to obtain. Moreover, use of a QDOT to defer the U.S. estate tax is made much more difficult. The survivor must seek a post-death QDOT and sever and transfer his or her fee interest to the QDOT. Finally, this joint tenancy approach leads to potential taxation of the property in each spouse's estate.

Canadian Corporation

To avoid direct ownership of U.S. situs assets, it has been relatively common for Canadians to invest in U.S. situs assets (particularly U.S. vacation homes and U.S. commercial real estate) through a non-U.S. holding company, such as a single-purpose Canadian corporation. Under this planning principle it is reasoned that what the individual owns at the time of death is simply stock in a foreign corporation, which is clearly not a U.S. situs asset. (A U.S. corporation would be ineffective because U.S. stocks are also U.S. situs assets for estate tax purposes.)

Thus, in such cases the U.S. estate tax issue is whether a look-through rule may be applied. It is the author's experience that although the IRS has long maintained that it routinely and successfully ignores such foreign holding companies (particularly single-purpose corporations and other holding companies that are wholly owned by the decedent), its success is merely anecdotal. Moreover, research indicates that there are no cases or rulings directly supporting the IRS position, even in analogous circumstances, except where the corporate formalities have not been followed or the corporation was found to be purely a nominee titleholder.

There are risks, however, to using single-purpose Canadian corporations. For one, Canadian tax authorities are revisiting the Canadian tax ramifications of this structure. It is my understanding that at least in the past, under Canadian tax law to comply with the Canadian single-purpose corporation rules and avoid shareholder benefit problems, the shareholders must essentially ignore the corporate structure and, for example, pay all of the expenses individually. Not only does this make the corporation appear to be simply a nominee title holder (thereby enabling the IRS to look through the entity under a long line of cases), but it would also seem to demonstrate the control and economic benefits retained by the individual shareholder. It also leads to a finding of any absence of fiduciary duties as well as the absence of economic or legal business constraints affecting the cash flow of the corporation.

An indisputable disadvantage of using a Canadian corporation for these purposes is the income tax effect. United States corporate rates are generally much higher than those for individuals, particularly with respect to realized capital gains. Corporations have no special capital gains rate, so it is quite likely that a substantial portion of the gain would be taxed at a 34 percent federal rate. As well, tax and legal compliance costs would be much higher for a corporation than for individually owned properties.

Partnerships

It is generally accepted that the income and the transfer tax regimes apply to partnerships that hold interests in U.S. real property (assuming that such partnership does not elect to be taxed as a corporation), regardless of whether the partnership is formed domestically or is foreign. For federal income tax purposes, therefore, there is conduit treatment, with the result that an individual Canadian NRA partner would ultimately receive the benefit of the individual income tax rates with respect to his or her share of partnership income, including realized capital gains on the sale of the U.S. real property interests by the partnership. Thus, there may be some advantage to a Canadian investor using a partnership if it yields individual income tax benefits while providing insulation from liability.

The general view is that partnerships are also look-through entities for U.S. estate and gift tax purposes, although there is no definitive up-to-date law in this area. See Richard A. Cassell, Michael J.A. Karlin, Carlyn S. McCaffrey, and William P. Streng, U.S. Estate Planning For Non-resident Aliens Who Own Partnership Interests, 99 Tax Notes 1683 (June 16, 2003). Thus, for example, a gift of a partnership interest during life where the partnership holds an interest in U.S. real property would be considered a taxable gift for U.S. gift tax purposes, and the Canadian NRA decedent's interests in such a partnership would be considered to hold a proportionate interest in the underlying U.S. real property and, accordingly, result in a U.S. situs estate.

This is not to say there is not substantial state law under which an interest in a partnership that continues after a partner's death is considered intangible property, and therefore potentially not subject to U.S. estate tax. A partnership interest is not included in the definition of U.S. situs assets under the Code. Therefore, in order to have exposure to U.S. estate and gift tax, the look-through rule must apply. The rulings that do exist in this area are at least 50 years old. But those rules do indicate that if a partnership's primary assets are interests in U.S. real property, then a proportionate amount of that interest would be included in the Canadian NRA partner's estate.

Irrevocable Trusts

When several members of a family intend to occupy the U.S. residential real estate, an irrevocable trust may be the best vehicle for avoiding exposure to any significant U.S. estate tax. To avoid U.S. estate tax inclusion under U.S. tax principles that tax persons with retained or broad interests in a trust, certain procedures must be followed. Before purchase, an individual who is providing the consideration for the purchase should create an irrevocable trust and contribute the cash to the trustee of such trust. The individual must not enjoy any economic benefits of the trust and must not be able to affect the beneficial enjoyment of any of the beneficiaries. Therefore, the individual should not be a trustee nor may he or she have any retained powers of appointment.

The individual's spouse and descendants may be discretionary beneficiaries. While the individual is married he may use the property "at the sufferance of his or her spouse." If the spouse dies first and the individual wants to continue to use the property (not as a guest of his or her children), then the individual would have to pay fair market rent. Of course, in the event of divorce, the individual loses use of the property.

The trust pays income tax at the same rates as individuals. Therefore, the lower 15 percent long-term capital gains tax rate is available on sale of the property. Moreover, the initial settlor of the trust may continue to contribute cash to the trust to cover the carrying costs. The trust would include sufficient provisions to prevent the inclusion of the underlying assets in the estates of any of the beneficiaries as well (e.g.: no general powers of appointment).

ESTATE PLANNING FOR A U.S. CHILD'S INHERITANCE FROM CANADIAN PARENTS ♦ In my view there are compelling reasons for the use of generation-skipping "dynasty" trusts when some children of Canadian parents have U.S. citizenship. The total amount of the inheritance passing to these U.S. children that would be allowed to be set aside in generation-skipping trusts is essentially unlimited under U.S. tax rules because Canadians are not subject to U.S. gift and estate taxes (except with respect to U.S. situs assets.)

The benefits of generation-skipping trusts for U.S. taxpayers are as follows:

◆ *Creditor Protection.* Although the trust assets will be available to be used for the child's benefit as well as for the benefit of the child's children and grandchildren, no creditor of theirs or of any of their children or grandchildren would be able to reach the assets held in this type of trust. Therefore, those generations would be able to use the trust assets, for example, to buy a primary residence or vacation home, and know that no claims against them or any member of their family would result in a lien against their home (as long as it is held in the trust.)

The terms of the Canadian spousal trust are virtually the same as those of a U.S. marital trust: the spouse must receive all of the income of the trust and only the spouse may receive "encroachments" of capital of the trust.

◆ *U.S. Estate Tax Exempt.* Although the U.S. child would have great access to the assets in the trust, the access generally is limited such that the value of the trust would be excluded from the child's personal estate upon his or her later death. Accordingly, grandchildren would inherit the benefits of this trust without any reduction for any U.S. estate taxes.

◆ *Continued Control.* Each child may be permitted to revise how the trust remainder would be distributed among family or other beneficiaries upon his or her death (subject to whatever limitations the parents desire). Moreover, the child may be a trustee of his or her own trust (within certain restrictions), and in that capacity may also be able to determine the lifetime distributions to family members.

To achieve this result I recommend that the child's trust be created by the parent during lifetime. Only nominal lifetime funding is required. Thus on death the parent's Canadian will may contain a "pour over" provision.

A BRIEF LOOK AT SOME CROSS-BORDER CLIENT SITUATIONS ♦

What follows is a description of some common cross-border client situations and how they should be analyzed under the tax regimes involved.

U.S. Person Is The Beneficiary Of A Canadian Trust

Although Canadian legislation and common law governing trusts may be far less extensive and comprehensive than in the United States, Canadians certainly create trusts as part of their basic estate planning. Particularly common would be testamentary trusts because of income tax benefits arising to the beneficiaries. Of these, a spousal testamentary trust may be the most common because it enables the deferral of all Canadian capital gains taxes that may otherwise have been payable on the death of the first spouse to die, and it gives an income tax rate benefit to the surviving spouse.

The terms of the Canadian spousal trust are virtually the same as those of a U.S. marital trust: the spouse must receive all of the income of the trust and only the spouse may receive "encroachments" of capital of the trust. Typically, on the death of the surviving spouse the trust remainder would pass to the children. Of course, your client happens to be one of the children and your client is a U.S. taxpayer.

This gives rise to the risk of a substantial tax liability on the part of your client when he or she inherits the remainder because of application of the U.S. foreign trust accumulation distribution ("throw-back") rules. The income that is typically paid out to the spouse is the ordinary income; realized capital gains are retained by the trust and reinvested, in the normal case. Unfortunately for the U.S. remainderperson, however, those reinvested capital gains are in fact accumulations which, ultimately, will be distributed as part of the remainder (in the appropriate proportions). There are two problems: first, the accumulations will lose their character as capital gains and be treated as ordinary income subject to tax at the highest individual rates; second, the deemed tax shortfalls, because accumulations were not distributed currently, are subject to compound interest.

The only ready administrative solutions are (1) to get rid of accumulations through distributions of an amount equal to the capital gains to the surviving spouse during his or her lifetime; or (2) if there are beneficiaries who are exclusively Canadian (or non-U.S.), to clear out accumulations by distributions of such amounts in a tax year before the year in which distributions are made to U.S. beneficiaries.

U.S. Taxpayer Holds A Direct Interest In A Canadian Investment Holding Company

The U.S. corporate anti-deferral rules may apply in this situation to either require inclusion currently of the U.S. shareholder's portion of undistributed corporate earnings (the controlled foreign corporation or "CFC," and the foreign personal holding company, or "FPHC," regimes), or to impose a punitive tax regime on later distributions or dispositions of the stock (the "passive foreign investment company or "PFIC" rules). (But note that the FPHC regime

The ultimate solution may well involve a variation of the trust and a severance of the U.S. beneficiary's interest in the trust or in the corporation, or both.

has been repealed for tax years beginning in 2005.) Planning solutions include converting the holding company to a Nova Scotia unlimited liability company before U.S. residency is established. An "NSULC" is treated as a pass-through entity for the U.S. income taxpayer (and therefore, no longer as a Canadian corporation), and should have no adverse tax consequences to the Canadian shareholders. Alternatively, the U.S. taxpayer's interest can be redeemed (hopefully before becoming a U.S. taxpayer). If that is not possible, the holding company should be administered so as to eliminate any deferral of the U.S. shareholder's interest in the earnings (in short, the QEF election should be made to avert PFIC status and dividends equal to the allocable share of earnings should be paid out).

U.S. Taxpayer Is A Discretionary Beneficiary Of A Trust That Was Created As Part Of A Canadian Freeze

Canadians still often use preferred stock recapitalizations, similar to those that were so popular in the United States before the enactment of Chapter 14. In such a recapitalization, the growth common stock is owned by a discretionary family trust. It is extremely likely that such trust is a foreign non-grantor trust. Thus, both the corporate and the trust anti-deferral regimes will be implicated in this situation.

There is no particularly attractive solution. As long as the underlying company remains active, it is possible that FPHC or PFIC status may be avoided (but note the repeal of FPHC rules effective for tax years beginning in 2005). The trust must be analyzed for all periods during which there were U.S. taxpayer beneficiaries to determine if there have been any accumulations. (In this case, there is rarely any deemed income; the only trust income would occur if the Canadian holding company paid dividends to, or redeemed stock of, the common stock shareholders, i.e., the trust.) If there were accumulations, distributions to the U.S. beneficiary should be made only in years in which the total distributions do not exceed the current year's distributable net income. The ultimate solution may well involve a variation of the trust and a severance of the U.S. beneficiary's interest in the trust or in the corporation or both.

Design Of Will For Two Canadian NRA Spouses With U.S. Situs Assets

In this situation one possibility is a formula bequest to a qualified domestic trust (or if the exposure to U.S. estate tax is small enough, to a Canadian spousal trust that would meet the marital deduction rules if the spouse were a of the U.S. citizen) with a U.S. by-pass trust to hold an amount equal to the prorated U.S. estate tax exemption. The term "by-pass trust" for these. purposes is simply one that would not be included in the surviving spouse's estate tax purposes. Therefore, it could be a Canadian spousal trust or it could be a

Canadian discretionary trust. The balance of the individual's assets could either pass to the spouse or a spousal trust, assuming that is desired for Canadian tax deferral purposes.

Design Of Will For A Married Couple, One A U.S. Citizen And One A Canadian Citizen

The U.S. spouse's Will should be standard marital deduction Will, providing that the marital share must pass to a trust for which a QDOT election may be made. If they are Canadian residents, the exemption amount may pass either to the spouse, or to a Canadian spousal trust or even a discretionary by-pass trust if the Canadian rollover is not needed for those assets.

Note that the U.S. citizen spouse should own all of the U.S. situs assets (at least to the extent of the U.S. estate tax exemption). The U.S. situs assets should pass to a by-pass trust so that they would not be included in the estate of the Canadian spouse when he or she dies.

Regarding the Canadian spouse's Will, one would not want the surviving U.S. citizen spouse to inherit outright (thereby increasing the amount potentially subject to U.S. estate tax), so everything that the Canadian spouse owns should pass to a by-pass trust (assuming that the Canadian citizen spouse is not a domiciliary of the United States). If the Canadian citizen spouse is a domiciliary of the United States, then traditional marital deduction planning would be appropriate.

APPENDIX

A Very Brief Annotated Bibliography Of Useful Resources For Canada/U.S. Trust And Estate Practice

Hanson, Suzanne, and Bussey, Sandra, *Death of a Taxpayer* (CCH Canadian, 7th ed. 2001). This soft-cover text summarizes the tax rules and tax compliance requirements occasioned by the death of a Canadian resident. Useful appendices include summaries of Canadian taxation applied to the non-resident decedent and a checklist of filing requirements.

Schoenblum, Jeffrey A., Editor, *A Guide to International Estate Planning: Drafting, Compliance, and Administration Strategies*, (ABA Section of Real Property, Probate and Trust Law, 2d ed. 2000). This compilation of 18 different articles spans the entire realm of international estate planning, covering both tax and non-tax issues. Among the titles are summaries of U.S. income and transfer taxation of non-resident aliens, estate administration and post-mortem planning considerations for the international client, planning for transfers to non-citizens spouses, emigration and expatriation, operating in the off-shore world, and, most relevant to this article, Wolfe Goodman's "Special Considerations in U.S.-Canada Estate Planning."

PRACTICE CHECKLIST FOR
Cross-Border Canadian-U.S. Planning

Although Canada has no estate tax and, therefore, no separate estate tax Treaty with the United States, the Income Tax Treaty includes provisions for the application of the U.S. estate tax to estates of Canadian citizens who are not U.S. residents at death as well as to U.S. citizens who are residents of Canada or own Canadian situs assets.

◆ What credits are available?

  - ◈ The Canadian capital gains tax on deemed dispositions at death is now treated as a foreign death tax credit, rather than merely a deduction.
  - ◈ Similarly, the U.S. estate taxes imposed on a Canadian decedent's U.S. situs asset (such as an Arizona condominium) may be used as a foreign tax credit against the Canadian federal income tax liability associated with such asset.
  - ◈ Under the Protocol, the estate of a non-U.S. citizen/resident is eligible for an expanded estate tax credit (the "pro-rated credit").
  - ◈ The Protocol permits a marital credit, in lieu of a marital deduction, on transfers at death to a surviving spouse equal to the allowable estate tax credit under certain circumstances.

◆ A U.S. citizen moving to Canada may avoid Canadian taxation on his or her investment income for the first five years of residence in Canada, provided that the investment assets are held in a qualifying immigration trust.

- ◈ Notwithstanding the possibility of being able to use a U.S. revocable trust as a Canadian immigration trust, it is generally advisable for U.S. citizens moving to Canada to revoke and distribute out the assets of their revocable trust and do their estate planning by will.

◆ What about Canadians moving to, living in, or buying property in the United States? Options for them include:

- ◈ Individually owned U.S. real estate;
- ◈ Holding an interest as a tenant-in-common;
- ◈ A non-U.S. holding company or partnership;
- ◈ An irrevocable trust (excludable from grantor's and all beneficiaries' estates) acquiring title.