# Trust and Estate Planning Considerations When Advising Canadians Living in the United States

**by**

**John L. Campbell**
**Kohnen & Patton LLP**
**www.kohnenpatton.com**

## Introduction

This article provides guidelines and techniques for advising Canadians who reside in the United States, either permanently or temporarily, about U.S. gift and estate taxes that may affect them. The article proposes estate planning ideas to keep in mind when advising Canadians residing in the United States. This article does not address income tax issues nor does it address U.S. gift and estate tax issues affecting Canadians residing in Canada who own U.S. assets.

## Applicable Legal Principles

Gifts and testamentary transfers by non-U.S. citizens who reside in but who are not domiciled in the U.S. are taxed differently from transfers by U.S. citizens and permanent residents. An individual who is not a citizen of the U.S. is considered domiciled in the U.S. at such time as that individual has moved to the U.S. with the intention to permanently remain in this country.[1] A person acquires a domicile in a place by living there, even for a brief time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[2] The intent of the individual, the crucial element of domicile, is determined from a number of factors to include the duration of stay in the United States, the location of family members,

[1] Treas. Regs § 25.2501-1(b).
[2] Treas. Regs. § 20.01-1(b).

houses and business interests, among other factors.[3] Visa status may be a guide to intent but in a recent case the court held that a Canadian decedent living in the U.S. on a non-immigrant temporary visa could form the intent to reside in the U.S. even though remaining in the U.S. would violate visa requirements.[4]

There is no tax on transfers by gift from a non-U.S. citizen who is not a domicile of the U. S. if such gifts are cash, investment assets, shares in companies (U.S. or otherwise) or other intangible property.[5] The only assets subject to U.S. gift tax for non-domiciliary, non-citizens will be gifts of tangible personal property or real estate located in the U.S.[6] If the gift tax is applicable, there is no exemption available[7] except for a limited marital deduction for gifts to non citizen spouses,[8] the annual exclusion of $10,000 for gifts to non spouses[9] or the unlimited marital deduction which applies only to gifts to U.S. citizen spouses.[10] Therefore, after the annual exclusion or marital deduction has been applied, the first dollar of value will be taxed by the U.S.

The taxable estate includes all property in the U.S.,[11] such as, real property located in the U.S., shares of U.S. companies, U.S. investments and money market accounts, and U.S. contracts and personal property located in the U.S. at the time of death. The taxable estate does not include U.S. bank deposits or U.S. life insurance.[12] If no treaty is applicable, as would be the case for Canadians who no longer reside in Canada, but are not domiciled in the U.S., the U.S. will tax assets to the extent that such assets exceed $60,000 in value.[13] The taxable estate includes the full value of real estate situated in the United States and owned directly by the deceased.[14] Recourse mortgages will only reduce the value of the U.S. taxable estate by a percentage of the mortgage which the U.S. asset bears to decedent's worldwide

---

[3] Tax Management Portfolio , Aliens – Estate, Gift and Generation Skipping Taxation, No. 837, page A-7, §II B (Tax Management, Inc. 2003)
[4] Jack Est. v. U.S., 54 Fed. CL. 590 (2002.
[5] I.R.C. § 2501(a)(2).
[6] *Id.*
[7] I.R.C. § 2505.
[8] I.R.C. § 2523(i). This exemption amount has been indexed to inflation and was $112,000 for 2003.
[9] I.R.C. § 2503.
[10] I.R.C. § 2523(a).
[11] I.R.C. § 2103.
[12] See I.R.C. § 2105(a) for life insurance and I.R.C. § 2105(b) for bank deposits.
[13] The tax on $60,000 is $13,000.00 for which there is an offsetting credit. *See* I.R.C. § 2102(c)(2)(A).
[14] I.R.C. § 2101.

assets.[15] Only the equity after reduction for any non-recourse mortgages is includible in the estate.[16]

Non-citizens, who are domiciled within the United States, are subject to estate tax and to gift tax on all transfers of assets regardless of where situated worldwide.[17] The applicable exemption equivalent is available to offset the estate and gift tax.[18] Transfers of worldwide assets at the death by a person, who is a U.S. citizen or non-citizen domiciled in the U.S., to a spouse, who is Canadian and not a citizen of the United States, are subject to estate tax; however, such assets can qualify for a limited marital deduction.[19] The marital deduction amount will be limited to the applicable exemption equivalent.[20] Assets held jointly between the husband and wife, where one spouse is a non-U.S. citizen, are presumed to be owned by the deceased spouse unless contrary evidence can be established.[21]

Assets passing to a qualified domestic trust (QDOT) for the exclusive benefit of the surviving non-citizen spouse will not be taxed until the assets are transferred from the QDOT or upon the death of the surviving non-citizen spouse, whichever first occurs.[22] A QDOT can be funded by terms of a Will or Trust of the first spouse to die or by the surviving spouse who has received an outright transfer of assets from the deceased spouse.[23] A surviving non-citizen spouse may not take advantage of the limited marital deduction available under the Canada-United States Protocol and also take advantage of the QDOT option, but must chose one of the two options.[24]

A foreign trust is any trust which is not administered under the primary supervision of a U.S. court, or any trust over which a non-U.S. citizen who is not a U.S. resident can exercise control of substantial decisions affecting the trust.[25] Assets transferred to a foreign trust, which is no longer owned by the transferor for U.S. income tax purposes, will be taxable at

---

[15] I.R.C. § 2106(a)(1) referencing I.R.C. § 2053.
[16] Regs. § 20.2053-7; Johnstone Est. v. Comr., 19 T.C. 44 (1952), acq., 1953-1 C.B. 5.
[17] See I.R.C. § 2001 for the estate tax and I.R.C. § 2501 for the gift tax.
[18] *See* I.R.C. § 2010 for the estate tax and I.R.C. § 2505 for the gift tax.
[19] 1997 Protocol to 1980 Canada-United States Income and Capital Tax Treaty, as Amended by 1983, 1984 and 1995 Protocols, Tax Management Foreign Income Portfolios, Business Operations in Canada, No. 955-3rd, Worksheet 32 (Tax Management, Inc. 2003), Article XIX.
[20] *Id.*
[21] I.R.C. § 2056(d)(1)(B) making I.R.C. § 2040(b) inapplicable for non citizen spouses.
[22] I.R.C. § 2056(d)(2). *See also* I.R.C. § 2056A.
[23] I.R.C. § 2056(d)(2).
[24] Regs. § 20.2056A-1(c)
[25] I.R.C. §§ 7701(a)(30)(E), 7701(a)(31)(B).

the time of transfer to that trust on the differential between the cost basis and the fair market value of such assets.[26] In addition, capital gains in a foreign trust which are not distributed outright to beneficiaries in the year of recognition are taxable as ordinary income when subsequently distributed.[27] Income earned in a foreign trust in one year and distributed in a subsequent year is taxable as ordinary income with an additional interest component.[28]

## Planning Techniques

Using the principals set out above, the following is a list of guidelines to employ when advising a Canadian citizen client.

1. When the client is neither a Canadian tax resident (having resided outside of Canada) nor a U.S. citizen nor a domicile of the United States,
    a. To the extent practical, the client should not invest directly in U.S. real estate and shares in U.S. companies or other U.S. *situs* assets, since these assets will be taxed at death on their value over the $60,000 exemption amount;
    b. The client should hold cash accounts in U.S. bank deposits and not in brokerage accounts or other non-U.S. bank deposits, since only U.S. bank deposits are excluded from the U.S. taxable estate;
    c. The client should divest himself or herself of U.S. *situs* assets by gifting intangible assets. Such intangible assets may be gifted without concern for U.S. gift taxes;
    d. If married to a U.S. citizen, the client should leave any assets which are not subject to U.S. estate tax in trust for the benefit of the surviving spouse
2. Canadian citizens, before establishing U.S. domicile, should insure that each spouse has at least ½ of the family assets in his or her name (up to $3,000,000 per spouse under the 2004 applicable exemption equivalent rules), so that upon

[26] I.R.C. § 684.
[27] I.R.C. § 643(a)(6)(C).
[28] I.R.C. § 643(a).

becoming a U.S. domicile, each spouse can make full use of the applicable exemption equivalent and available marital deduction at death.

3. When purchasing U.S. real estate in joint names, non-citizen clients should transfer the funds for that purpose into separate but equal accounts prior to purchasing the real estate. Furthermore, before purchasing real estate, the clients' long-term estate planning objectives should be considered. While it is possible to transfer intangible investments and the bank accounts tax free, any subsequent transfer of real estate will be a taxable transfer.
4. When drafting Trusts for Canadians residing in the U.S., the Trust provisions should leave the assets outright to the surviving non-citizen spouse, with the option to disclaim the assets to a QTIP Marital Trust with QDOT provisions. This will allow the non-citizen spouse a number of options:
    a. If planning to remain in the U.S., the surviving non-citizen spouse can disclaim assets equal to the applicable exemption equivalent, allowing these assets to fund a bypass trust. These assets would not be taxed by the U.S. upon the subsequent death of the surviving spouse.
    b. If planning to return to Canada following the death of the spouse, assets in value not to exceed the applicable exemption equivalent can be taken outright and removed from the U.S. without any U.S. estate or gift tax exposure.
    c. The surviving non-citizen spouse may decide to take advantage of the limited marital deduction available under the Canadian/American protocol and pay estate tax on any assets which exceed the available marital deduction;
    d. If the remaining assets exceed the limited marital deduction provided under the Canadian/American protocol, the surviving non-citizen spouse may decide to disclaim the assets to the QDOT created under the deceased spouse's Trust.
    e. If the remaining assets exceed the limited marital deduction provided under the Canadian/American protocol the surviving non-citizen spouse

may decide to take the assets outright and place them in his or her own QDOT.

5. In drafting a bypass trust for which the non-citizen spouse is the beneficiary, one should allow for a termination of the trust if the surviving spouse returns to Canada.
6. Where a Canadian is married to a U.S. citizen, all assets should be left to a QTIP trust giving the Trustee the option not to make the QTIP election as to assets not subject to U.S. estate tax or assets for which a credit is available, while taking the QTIP election for all other assets which are subject to U.S. estate taxes.
7. **Do not** change the ownership of U.S. real estate owned by non-citizens from one spouse to another or from joint name to the name of one spouse without full consideration of the gift tax ramifications, noting that non-domiciliaries do not have access to the applicable exemption equivalent.
8. **Do not** give gifts of personal property located in the United States.
9. **Do not** give as gifts checks drawn on U.S. banks because such checks have, in the past, been considered personal property by the IRS. Give instead either cash or checks drawn on banks outside the United States.
10. **Do not** retain assets in joint name, where it is difficult to determine the source of those assets, since the presumption is that such assets are owned by the deceased spouse.
11. **Do not** appoint a non-citizen as trustee of a marital or bypass trust unless it is certain that the non-citizen will remain resident in the United States. A non-citizen non-resident should not be given the power to remove trustees or appoint successor trustees since such power will cause the trust to become a foreign trust.

## Conclusions

As a result of the U.S./Canadian protocol, there are special tax advantages for Canadians residing in the United States, when compared to that which are available to citizens of other countries. However, these advantages are only available for persons who are Canadian residents or U.S. domiciliaries at the time of death. Full analysis of the client's situation is essential at the outset, focusing, in particular, on whether the client is a Canadian resident and what the U.S. domiciliary implications are for the client. Once residence and domiciliary issues have been determined, careful application of the appropriate provisions discussed in this article should be of assistance in advising the Canadian client.

158410.5