TREATY TIPS & TRICKS

David A Altro and **Matt Wolch** discuss the US estate tax and testamentary planning strategies available to US and Canadian taxpayers

KEY POINTS

WHAT IS THE ISSUE?
An analysis of US estate tax, and the tax and estate planning opportunities available to US persons and Canadian residents.

WHAT DOES IT MEAN FOR ME?
A discussion of the applicable exclusion amount, tax credits available under the *Internal Revenue Code* and the *United States-Canada Income Tax Convention*, and testamentary planning that can be incorporated into a will.

WHAT CAN I TAKE AWAY?
Practitioners will have an understanding of the estate tax issues that may apply to their clients and the various planning options for dealing with these issues.

ESTATE TAX IS a transfer tax levied by the US on the value of assets owned or considered to be owned at death. Estate tax can apply at a maximum rate of 40 per cent. The US allows taxpayers to transfer a certain amount of assets tax free, either during life or on death – the applicable exclusion amount (AEA). The recent US *Tax Cuts and Jobs Act* doubled the AEA to USD10 million (indexed to inflation) for deaths occurring after 31 December 2017 and before 1 January 2026. The AEA will revert to USD5 million (indexed to inflation) for deaths occurring after 31 December 2025.

US PERSONS v NON-US PERSONS

For estate tax purposes, 'US persons' refers to US citizens and domiciliaries, i.e. those who have moved to the US with an intention of remaining there indefinitely. US persons and all their assets, including life insurance, are subject to the estate tax regime, regardless of where in the world they reside. Non-US persons are subject to estate tax only on their US-*situs* assets – e.g. US real estate and shares of US corporations.

THE APPLICABLE CREDIT AND EXCLUSION AMOUNT

A US person's first defence against estate tax is the applicable credit in s2010 of the *Internal Revenue Code* (the Code), which allows a US person to transfer assets valued at up to the AEA free of estate tax. The applicable credit is equal to the estate tax liability that would result from a taxable estate valued at the AEA. For deaths occurring in 2018, the AEA is USD11.2 million and the applicable credit is valued at USD4.4258 million.[1] This means that a US person with worldwide assets valued at less than USD11.2 million will not pay any estate tax if they die in 2018.

THE TREATY CREDIT

Under US law, non-US persons can only transfer US-*situs* assets up to USD60,000 free of estate tax. However, Canadian residents can claim a non-refundable credit against estate tax under art.XXIX(b) of the *United States-Canada Income Tax Convention* (the Treaty), known as the Treaty Credit. This is calculated by multiplying the applicable credit available to a US person under the Code (i.e. USD4.4258 million) by the ratio of the Canadian's US-*situs* assets to worldwide assets. For example, a Canadian with US-*situs* assets valued at USD2 million and worldwide assets valued at USD10 million would be entitled to a Treaty Credit of USD885,160.[2] The Treaty Credit ensures that a Canadian

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resident with worldwide assets valued at less than the AEA will not pay any estate tax. The Treaty Credit can be doubled if assets are left to a surviving spouse.

The Treaty Credit is claimed by filing a non-resident US estate tax return (Form 706-NA). All assets of the deceased spouse must be disclosed in accordance with US tax rules. Penalties can result if assets are undervalued. Form 706-NA must be filed within nine months of death, otherwise Treaty benefits may be denied. However, an extension of time to file may be requested. If Form 706-NA is not filed, the beneficiaries may inherit the US-*situs* assets with a cost base equal to zero. When the beneficiary subsequently disposes of the asset, the entire proceeds could be taxed as a capital gain.

US SPOUSES – UNLIMITED MARITAL DEDUCTION AND PORTABILITY

US persons can transfer any amount of assets to their US citizen spouses tax free by virtue of the unlimited marital deduction. Generally, assets must be left to a surviving spouse outright to qualify for the marital deduction; transfers to a trust providing a mere lifetime interest do not qualify. An exception exists for transfers to a qualified terminable interest property (QTIP) trust. A QTIP is a special trust where the surviving spouse must receive at least a lifetime income interest. Transfers to a QTIP qualify for the marital deduction and allow a testator to maintain control over the distribution of the assets after the death of the surviving spouse. A QTIP trust can be particularly useful in situations where children from prior marriages are involved.

By utilising the marital deduction to transfer assets tax free at death, an individual can preserve their unused AEA, which can be claimed and utilised by the surviving spouse. Portability allows the surviving spouse to claim their deceased spouse's unused AEA. Portability must be elected in the deceased spouse's US estate tax return (Form 706), filed within nine months of death. Form 706 must be filed to elect portability, even if no estate tax is owing.

MIXED SPOUSES – THE TREATY CREDIT v QDOT ELECTION

The marital deduction does not apply to transfers to a spouse who is not a US citizen. US spouses can still transfer assets valued at up to the AEA to their Canadian spouses tax free at death; however, an election needs to be made with respect to assets in excess of the AEA. If the US spouse's worldwide assets are less than twice the AEA, their estate can elect to claim the marital credit under the Treaty to avoid estate tax.

Alternatively, the estate could elect to hold the excess assets in a qualified domestic trust (QDOT). A QDOT is a trust set up for the exclusive benefit of a non-US spouse. For a trust to qualify as a QDOT, at least one trustee must be a US citizen or US corporation. A QDOT does not avoid estate tax, it defers the estate tax liability until the earlier of: the date the asset is distributed out of the QDOT, or the death of the surviving spouse. Upon either of these events, tax is imposed on the distributed QDOT principal at the rate that would have applied to the estate of the first to die. A QDOT may be incorporated into the deceased spouse's will or set up after death. The QDOT and Treaty benefits elections are mutually exclusive; the estate must elect one or the other.

MIXED SPOUSES – EXEMPT v INCLUSION TRUSTS

Canadian residents need to consider estate tax when deciding how to bequeath assets to their US spouses. If the US spouse already has estate tax exposure, assets can be transferred to an 'exempt trust' to avoid increasing this exposure. An exempt trust is specially drafted to provide the US spouse with beneficial use of trust assets during their lifetime, while shielding those assets from estate tax upon the death of the US spouse. If the US spouse has no estate tax exposure, assets can be bequeathed in a manner that does not protect against estate tax, but achieves an increase in cost base at the date of the US spouse's death. Consideration should also be given to the deemed disposition that will occur at death under Canadian law and foreign tax credits that may be available to offset estate tax.

There are tax and non-tax disadvantages associated with exempt trusts. From a tax perspective, the assets in an exempt trust will not receive a cost base 'bump up' to fair market value at the date of the surviving spouse's death. As a result, remainder beneficiaries may have increased exposure to capital gains tax if they inherit assets through an exempt trust. From a non-tax perspective, the estate tax protection is achieved by limiting the surviving spouse's control over distributions of capital to themselves, which makes administering the trust more complicated if an independent trustee is required.

Flexibility can be incorporated into the Canadian spouse's will so that a determination can be made at the time of death whether to fund an exempt trust with estate tax protection for the surviving spouse, or pass assets to a different trust (or outright) that will increase the asset cost basis on the second spouse to die.

CONCLUSION

Estate tax must be considered by US persons and Canadian residents with US spouses or US-*situs* assets. Although a substantial amount of assets can be transferred tax free by virtue of the AEA and credits available under the Code and the Treaty, taking advantage of Treaty benefits requires the timely filing of Form 706 or 706-NA.

Although planning is available to avoid or mitigate estate tax exposure, much of this planning must be implemented prior to death and relies on tax credits that are subject to change. A better option may be to restructure assets during life to avoid estate tax issues that could arise on death.

1 USD345,800 + [40 per cent * (USD11.2 million – USD1 million)] = USD4.4258 million **2** USD4.4258 million * (USD2 million / USD10 million) = USD885,160

DAVID A ALTRO TEP IS MANAGING PARTNER, AND **MATT WOLCH** IS AN ASSOCIATE, AT ALTRO