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How to plan for the increased U.S. estate tax exemption

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The increase in the U.S. estate tax exemption to $3.5 million presents both new planning opportunities and potential pitfalls for Canadian residents.

The estate tax exemption available to U.S. citizens and residents increased to $3.5 million on Jan. 1. The U.S. estate tax is set to repeal effective Jan. 1, 2010, but practitioners expect last-minute legislation that will keep the estate tax in place through 2010 and beyond, probably with a $3.5 million exemption.

A Canadian who owns U.S. assets, such as U.S. real property or stock in a U.S. corporation, is subject to U.S. estate tax at death. The U.S.-Canada Income Tax Treaty gives Canadian residents (other than U.S. citizens) a prorated exemption which is calculated by multiplying the exemption available to U.S. citizens (currently $3.5 million) by the value of the Canadian resident's U.S. situs assets over the value of worldwide assets.

Under this formula, the greater the percentage of a decedent's assets that are in the U.S., the greater the prorated exemption. Accordingly, U.S. estate tax exposure can often be minimized if U.S. property is owned by the "poorer" spouse.

For instance, take a typical situation of a Canadian couple who owns a vacation home in Florida. The husband's net worth is $2 million, all of which is located in Canada. The wife's net worth is $10 million, which includes $9 million in Canadian assets and the $1 million Florida vacation home. Under their current plan, if the wife dies first, all of her assets pass to the husband outright. After applying the prorated exemption, and assuming her estate claims the treaty marital credit, which effectively doubles the prorated exemption, the wife's estate would owe roughly $55,000 in U.S. estate tax. If the husband still owns the Florida home on his death, his estate would owe roughly $224,000 in U.S. estate tax.

Under the best planning, the Florida home would have been purchased through a U.S. trust, which would keep the house out of both spouses' estates. The wife could sell the house to a trust now, but the sale would trigger U.S. capital gains tax if the house has increased in value.

As an alternative, the couple's estate plan could be optimized by transferring the Florida home to the husband, who owns far less property in his own name. Spouses who are not U.S. citizens can only transfer up to $133,000 a year to each other without triggering the U.S. gift tax (this amount is indexed for inflation), so the transfer would have to be completed over several years. If the wife transfers the house to her husband and then he predeceases her, the exemption allowed to his estate, $1.67 million, would completely shelter the house from the estate tax. In addition, if they update their wills so that the house passes into a properly structured trust for the wife, the house will be sheltered from estate tax on her death. Overall, these simple changes would save roughly $279,000 in U.S. estate tax.

While the much higher U.S. estate tax exemption is good news in itself, it may have unintended results for cross-border couples. The typical estate plan for a U.S. citizen relies on a formula that gives the surviving spouse the "amount that will reduce the U.S. federal estate tax payable by my estate to the lowest possible amount." While this formula has the advantage of automatically adjusting to the frequent changes in U.S. tax law, the significant increase in the U.S. estate tax exemption over the last decade may have unintentionally altered older estate plans.

For example, assume a second marriage where the husband is a U.S. citizen living in Canada, and the wife is a Canadian citizen and resident. The husband has adult children from his first marriage. When the couple put their estate plan in place in 1998, the husband had a net worth of $4 million, and the U.S. exemption was $625,000. They agreed that if the husband died first, the husband's children from his first marriage should receive part of their inheritance immediately.

The husband's will includes the typical formula, giving the wife the amount necessary to reduce the federal estate tax to zero, meaning that she will receive any assets exceeding the exemption amount. He leaves the exemption amount to his children, intending that they would receive $625,000 and his wife would receive the balance of his estate.

In 2009, the husband's net worth is still $4 million, an assumption that might have seemed incredible until the recent economic collapse. Because of the increase in the estate tax exemption, $3.5 million now goes to the husband's children, and his wife must get by with only $500,000, a result that is far from their original intent.

Practitioners with clients who have U.S. estate tax exposure should review existing plans to determine if the increased exemption has altered the plan in an unintended manner. ■

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