

Estate Planning for Canadians with U.S. Connections

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Agenda

- Overview
- Key concepts
- Estate planning for US citizens
- Estate planning for nonresident aliens
- Other issues

Canada vs. US – An Overview

	Canada	United States	States
Taxation basis	Residency	Citizenship	Residency
Joint filing?	No	Yes	Yes
Top marginal rates:			
• Regular income	39% to 50%	39.6%	0% to 11%
• Dividends:			
• Regular	28% to 38%	43.8%*	0% to 11%
• Preferential	19% to 36%	23.6%*	0% to 11%
• Capital gains	19% to 25%	23.6%*	0% to 11%
Top tax bracket	\$150,000 (NS)	\$450,000 (MFJ)	\$3k to \$1m+
Tax on death	Capital gains 25% (NS)	Estate tax 40%	Estate tax 0% to 19%
			Inheritance tax 0% to 10%
* Includes 3.8% Obamacare surtax			
Tax on gift	Capital gains	Gift tax	None or Gift tax

Key Concepts

- US income tax
- Controlled foreign corporations (CFCs)
- Passive foreign investment companies (PFICs)
- Foreign trust rules
- US estate tax
- US gift tax
- US estate planning techniques

Income Taxes

- U.S. citizens and residents taxable on worldwide income
 - U.S. Citizen
 - Resident alien
 - Permanent resident (“green card”) test
 - Substantial presence test
 - Closer connection
 - Canada-U.S. Tax Convention – Paragraph IV:2
- Nonresident aliens taxable only on U.S. source income
 - Effectively connected with U.S. trade or business (ECI/ETBUS)
 - Passive income (FDAP)
 - Canada-U.S. Tax Convention

Controlled Foreign Corporations

Overview

- CFC if > 50% of the votes or value owned by U.S. shareholder(s)
- U.S. shareholder
 - U.S. person that owns 10 percent or more of the total votes of all classes of stock that have vote entitlement
 - Attribution of ownership rules are complex

Implications

- Include certain undistributed earnings (Subpart F income) in shareholders' income
- Onerous reporting requirements

Planning

- Avoid if possible
- Match actual distributions with Subpart F inclusion

Passive Foreign Investment Companies

Overview

- PFIC if either:
 1. Income test - $\geq 75\%$ of gross income is passive, or
 2. Asset test - $\geq 50\%$ of assets held for production of passive income

Implications

- Punitive tax and interest on “excess distribution” or sale of PFIC shares
- Complex tax reporting

Planning

- Avoid if possible
- Qualifying Electing Fund (“QEF”) election
 - Shareholder deemed to receive annual distribution of E&P
- Mark-to-market election

Foreign Trusts

- Foreign vs. domestic
 - Court test
 - Control test
- Foreign grantor trust
 - US person (grantor) directly or indirectly, gratuitously transfers property to a foreign trust, and
 - Grantor retains certain powers over the trust , or
 - Trust has one or more US beneficiary
 - Grantor is treated as the owner of the trust property and must report trust income

Foreign Trusts

- Foreign non-grantor trust
 - Trust is not taxable to US (except as nonresident alien on US source income)
 - US beneficiaries are taxable on distributions:
 - Current distribution
 - Income retains character
 - Accumulation distribution = throwback rules
 - Taxed as ordinary income
 - Taxed in year of accumulation
 - Subject to interest charge
 - Complex reporting requirements

Estate Tax

- Applies to U.S. citizens, residents and nonresident, non-citizens
- Based on fair market value of worldwide estate
- Exemption of USD 5.25m (indexed)
- Exemption now portable
- Deductions
- Tax rates - 18% to 40%
- No sunset clause

Estate Tax

Who does it apply to?

- US citizens
- US residents
 - Residence means “domicile”
 - Physically present with intent to remain indefinitely
 - Question of fact
 - Treaty tie-breaker not available
 - Snowbirds
- Nonresident, non-citizens (NRNRs)
- State estate tax

Estate Tax

- Computation
- Gross estate
 - the value of all property that the decedent had an interest in at the time of death
 - Includes:
 - Life insurance proceeds
 - Interests in some grantor trusts including RRSPs/TFSA's
 - 100% of value of JTWROS interest with non-citizen spouse
 - Certain transfers within three years of death
- Valuation
- Stepped up basis

Estate Tax

Taxable Amount Over	Taxable Amount Not Over	Tax on Amount in Column A	Rate of Tax on Excess Over Amount in Column A
\$0	\$10,000	\$0	18%
\$10,000	\$20,000	\$1,800	20%
\$20,000	\$40,000	\$3,800	22%
\$40,000	\$60,000	\$8,200	24%
\$60,000	\$80,000	\$13,000	26%
\$80,000	\$100,000	\$18,200	28%
\$100,000	\$150,000	\$23,800	30%
\$150,000	\$250,000	\$38,800	32%
\$250,000	\$500,000	\$70,800	34%
\$500,000	\$750,000	\$155,800	35%
\$750,000	\$1,000,000	\$248,300	39%
\$1,000,000	\$5,250,000	\$345,800	40%
\$5,250,000	–	\$2,045,800	40%

Estate Tax

- Deductions:
 - Marital transfers
 - Charitable contributions
 - State estate tax
- Portability of exemption:
 - Surviving spouse's exemption increased by deceased spouse's unused exemption (DSUE)
 - Must timely file Form 706 to elect

Gift Tax

- Applies to U.S. citizens, residents and nonresident, non-citizens
- Applies to property transferred for < full consideration
- Shares unified credit with estate tax and generation skipping tax (GST)
- Marital/charitable deduction
- Annual exclusions:
 - USD 14,000 per donee
 - USD 143,000 for non-citizen spouse
- Tax rates – 18% to 40%
- Carryover basis

US Estate Planning

- Focus areas
 - US estate tax
 - Probate taxes
- Strategies
 - Lifetime gifting
 - USD 14,000 per donee
 - USD 143,000 for non-citizen spouse
 - Spousal trusts
 - Bypass (or credit shelter) trust
 - Marital deduction trust
 - Qualified terminable interest property trust (QTIP)
 - Dynasty trust
 - Irrevocable life insurance trust (ILIT)
 - Revocable Living Trusts

Estate Planning for US Citizens Resident in Canada



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US Citizen with Canadian Spouse

- US Citizen is a US person and subject to US estate tax on his or her gross estate
- Because he or she is married to a non-US citizen, the unlimited marital deduction is not available for US estate tax or gift tax
- The full value of any property held jointly with the spouse will be subject to US estate tax since a non-citizen spouse is not a joint owner for US estate tax purposes

US Citizen with Canadian Spouse

- Make annual *inter vivos* gifts to spouse
 - Annual gifting exemption \$143,000
 - Estate equalization objective
- Gifts should be properly documented and recorded
- Gift will be tax deferred for Canadian tax purposes (subject to attribution)

US Citizen with Canadian Spouse

- Make annual *inter vivos* gifts to other (non-spouse) beneficiaries
 - Annual gifting exemption of \$14,000
- Educational or Medical Expense Exclusion
 - Payments made for certain educational and medical expenses of another person are not subject to the gift tax and will not be applied against the annual exemption

US Citizen with Canadian Spouse

- Inter vivos gift up to \$5.25 M
- To Canadian spouse – file US Gift Tax return
 - Canadian spouse’s will should provide that assets transfer to spouse trust if Canadian dies first
- To Family Trust – file US Gift and GST return
 - Spouse, children and grand children beneficiaries
 - Creates “dynasty” trust to protect US citizen children and grand children from US estate trust
- Protects \$5.25 M capital plus growth from US estate tax

US Citizen with Canadian Spouse

- Testamentary gift of first \$5,250,000 to spousal trust and/or family trusts
 - Tax free transfer
- Property with net gain should be transferred to spousal trust to have benefit of spousal rollover for Canadian deemed disposition rules
 - Balance to family trust
- Any available tax credits may be utilized in respect of amounts in excess of the basic exclusion amount.
- Spousal/family trust is a by-pass trust for US estate tax purposes
 - In event spouse subsequently becomes US taxpayer

US Citizen with Canadian Spouse

- Qualified Domestic Trusts (“QDOT”) for gifts over \$5,250,000 to Canadian spouse
 - Eligible for the estate tax marital deduction
- QDOT will be a testamentary spousal trust for Canadian tax purposes
 - Property indefeasibly vesting with spouse within 36 months
 - Surviving spouse entitled to all income
 - During his or her lifetime only surviving spouse entitled to any income or capital of the QDOT

US Citizen with Canadian Spouse

- 7 Requirements to be QDOT...
 1. Property passing must be included in the surviving spouse's estate
 2. At least one of the trustees must be a US citizen or domestic corporation
 - If assets more than \$2 Million than either (i) one trustee must be a US bank; or (ii) US trustee must furnish the IRS with a bond/irrevocable letter of credit equal to 65% of value of assets
 3. All income must be paid to spouse annually

US Citizen with Canadian Spouse

- 7 Requirements to be QDOT, cont'd...
 4. No principal may be distributed to spouse unless trustees withhold estate tax thereon
 5. QDOT election must be made on deceased's return
 6. QDOT must comply with US regulations
 7. If QDOT assets more than \$2 Million, trust must provide that no more than 35% of the assets value may be invested in real estate outside of US

US Citizen with Canadian Spouse

- Qualified Domestic Trust
 - Estate tax imposed on corpus distributions from the trust prior to spouse's death, and on the value remaining in the trust on the date of death of spouse.
- Estate tax is not imposed on distribution of income.

US Citizen with Canadian Spouse

- Canadian spouse may become US citizen prior to US Citizen's passing, and be able to claim the marital exemption
- Common technique is to leave outright gift to in will to spouse
 - Spouse should have option to disclaim all or part of gift
 - Disclaimed gift would then pass to a QDOT for the spouse

US Citizen with Canadian Spouse

- Canada US Tax Treaty Article XXIX B, para 3
 - Marital credit can shelter \$10.5 Million from US estate tax
- To qualify for credit:
 - Deceased is citizen or resident of US
 - Spouse is resident of Canada or US
 - If both resident of US, at least one was Cdn citizen
 - Elect benefit of this provision, and waive entitlement to marital deduction (no QDOT)

US Citizen with Canadian Spouse

- Life insurance included for US estate tax purposes if US citizen has any of the incidents of ownership
 - Right to change beneficiaries or their share
 - Right to cash in policy
 - Right to borrow against policy
 - Right to pledge the policy
 - Right to assign or cancel the policy
- Corporate owned insurance included if US citizen controlling shareholder

US Citizen with Canadian Spouse

- Move life insurance from control of US citizen
 - Watch US gift tax if existing policy has value
 - Canadian spouse must fund future premiums
- Irrevocable Life Insurance Trust (“ILIT”)
 - Canadian trust is owner of insurance policy
 - US Citizen spouse is not a trustee
 - Family members are beneficiaries
 - Funded out of \$5.25 M Gift and GST exemption, or
 - Funded out of annual gift exemptions (provided beneficiaries have certain withdrawal rights)

Canadian with US Citizen Spouse

- Spousal trust in will of Canadian for benefit of US spouse
 - Spousal trust for Canadian tax purposes.
- US spouse may be sole trustee
- Gift over to separate trusts for children / grandchildren on death of spouse
- Objective is to keep assets out of estate of US spouse and residual beneficiaries for US estate tax purposes...

Canadian with US Citizen Spouse

- No general power of appointment over principal
- Entitled to all income (including gains) to avoid US throw back rules
- Discretionary capital entitlement
- 5 and 5 power (right to demand greater of \$5,000 and 5% of capital per year)
- US spouse can be a trustee, but cannot participate in decision to distribute to self above ascertainable standard
 - Health, support, maintenance, education

Canadian with US Citizen Spouse

- Common for Will to provide language that beneficiaries other than the surviving spouse will receive an amount equal to the available estate tax exclusion
 - Remainder of estate to spouse
 - Marital deduction
 - Estate tax is entirely avoided
- Having regard to \$5,250,000 exemption, must ensure sufficient assets for spouse.

US Citizen Couple in Canada

- Combination of marital deduction trust and non-marital deduction trust
- Non-marital trust provides the surviving spouse with needed income during his or her life
 - Utilizes exemption of first to die spouse in event portability is lost
 - If survivor lacks control over trust, the assets are not included in his or her estate on subsequent death
 - Participation in distribution of capital limited to ascertainable standard

US Citizen Couple in Canada

- Make annual gifts to spouse and other beneficiaries
 - Annual gifting exemption of \$14,000
 - Could help equalize estate between spouses
- Gift Splitting
 - One spouse may gift \$28,000 per annum per beneficiary
 - Other spouse simply consents to gift
 - Full amount qualifies for annual gift tax exclusion

US Citizen Couple in Canada

- Beneficiary Controlled Trust
 - Parents fund up to to \$28,000 in an irrevocable trust for benefit of adult child
 - Adult child is trustee and discretionary beneficiary
 - Adult child's right to withdraw capital is limited to ascertainable standard
 - Parents have no interest in trust
 - Adult child is treated as the “owner” of the trust
 - Since child has not contributed to the trust the trust assets will not be part of child's estate
 - Growth and additional gifts will attribute to value of trust

US Citizen Couple in Canada

- Educational or Medical Expense Exclusion
 - Payments made for certain educational and medical expenses of another person are not subject to the gift tax and will not be applied against the annual exclusion
- Split Gifts to Spouse and Charity
 - Form of annuity or unit trust
 - Special exception to the rule that terminal interest not eligible for marital deduction
 - Marital deduction for value of annuity or unit trust income
 - Charitable deduction for remainder interest

Pitfalls for US Citizens in Canada

- Canadian freeze
 - Income recognition
 - Gift tax
- Family Trusts
 - Grantor Trusts
 - US beneficiaries
- US Limited Liability Companies (LLCs)
- Canadian post-mortem planning
- Liability of Executors for unpaid US Tax

Estate Planning for Nonresident Aliens



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What is a Nonresident Alien?

- Not defined on what it is – defined on what it is not:
- NRA is anyone that is not a:
 - US Citizen or
 - Resident Alien:
 - Lawful permanent resident (“green card”),
 - Substantial presence test
 - 183 days or more (3 year weighted average),
 - Lots of exceptions and clarifications (i.e. students, physical days, etc.)
 - Closer connection exception (the snowbird exception)

Nonresident Aliens - Taxation

- General US taxation of NRA's
 - Withholding taxes vs. tax liability important:
 - W-8BEN and W-8ECI (reduce or eliminate withholdings)
 - Income effectively connected with a U.S. trade or business (“ECI”):
 - Employment, business income (A presence in the US required)
 - Article XV – Income from employment
 - Article VII and V – Business profits and PE
 - Be careful of deeming provisions in the treaty
 - FIRPTA
 - Fixed, determinable, annual, periodic income (“FDAP”)
 - Estate and gift tax on U.S. situs property

Nonresident Aliens - Taxation

- US real property
 - Rental
 - 30% withholding tax (FDAP) unless classified as ECI
 - Withholding agent to provide form 1042S
 - Election to be taxed on a net basis sent to IRS and complete W-8ECI
 - File US tax return and determine tax liability on a net basis.
 - Sale of property
 - FIRPTA
 - 10% withholding tax on gross proceeds
 - Withholding certificate available to reduce withholding
 - US tax return required to report sale

Nonresident Aliens – Potential Problems

- Sojourning in US – (treaty protection)
 - Meet substantial presence test
 - Closer Connection – no longer valid if ≥ 183 days in current year
 - Claim treaty residency tie-breaker rules
 - File 1040NR and treaty-based return 8833
- Sojourning in US – change of residence (no treaty protection)
 - Rules of the game change – world wide taxation
 - Holding company – lost CCPC status
 - Non-resident to Canada – Part XIII tax
 - Departure tax
 - Foreign reporting to IRS
 - US estate tax/gift
- Owning US Situs property
 - Estate/gift tax
 - FIRPTA
 - FDAP

Nonresident Aliens – Estate Tax

- Fundamental difference for Estate tax between US Citizens and NRA's:
 - Citizens = All property
 - NRA's = US situs property
- NRA's estate tax based only on FMV of **US situs** property owned at death
- US\$5.25m (pro-rated) exemption available to offset estate tax
- NRA common estate tax issues:
 - What is US Situs property?
 - What is included in worldwide estate?
 - How do you value property?
- Where do we start when looking at NRA's estate tax?

Nonresident Aliens – Estate Tax

- Worldwide estate:
 - If worldwide estate < US\$5.25m – No US estate tax
 - If worldwide estate > US\$5.25m
 - If US Situs property < US\$60,000 – no estate tax
 - If US Situs property > US\$60,000 – estate tax return required
 - Return required regardless of actual liability
 - Important if trying to transfer assets
 - Federal transfer certificate might be required

Nonresident Aliens – Estate Tax

- If US estate taxes could be an issue, very important to address:
 - What is US Situs property?
 - What is worldwide estate property?
 - How do you value?

Exemption formula:

- Unified credit equals \$2,045,800 (\$5.25m x eff. rate - 38.967619%)

FMV US Situs property

US\$2.0458m X FMV of world wide estate = exemption

Nonresident Aliens – Estate Tax

- Simple example:
 - US Situs property of \$1,500,000 US securities
 - Worldwide estate of \$10,000,000 (non-US Situs property)
 - Single NRA (no spouse)
 - Pro-rated exemption available is \$306,870 (15% pro-rated)

Unified credit formula:

$$\text{US\$2.0458m} \times \frac{\$1,500,000}{\$10,000,000} = \$306,870$$

Nonresident Aliens – Estate Tax

- Simple example (*continued*):
 - US gross estate tax = \$545,800
 - US unified credit = \$306,870
 - US net estate tax = \$238,930
 - Does not factor in possible deductions or other credits available

Nonresident Aliens – Estate Tax

- Common US situs property
 - US real estate
 - Assets of a trade or business conducted within the US
 - Shares in publicly traded US companies (location of broker or exchange traded on are not relevant)
 - Tangible property in US (vehicles, art, boats, jewelry, etc.)
 - US retirement plans (IRA's, 401k's, etc.)
 - Deposits in US brokerage account (excluding bank deposits)
 - US securities held in Canadian registered accounts (TFSA, RRIF, RESP's, RDSP's, or RRSP's)
 - US securities held in various other forms (alter-ego trust, joint spousal trust, etc.)

Nonresident Aliens – Estate Tax

- Common worldwide property
 - All property described on previous slide regardless of US situs or non-US situs.
 - Life insurance you owned on your death (beneficiary not relevant – ownership is relevant)
 - 100% of property (JTWROS) – (exclusion if capital contributed)
 - Property held in a grantor trust (examples: RRSP, TFSA, alter-ego, etc.)
 - Publicly held Canadian or other foreign securities,
 - Privately held Canadian or foreign securities,
 - Canadian or other real property,
 - Personal property

Nonresident Aliens – Estate Tax

- Common planning opportunities for NRA's
 - Canada-US tax treaty article XXIXB:3
 - FTC planning – plan to match CN death tax and US estate tax
 - Alternative investment decisions (i.e. reduce US situs assets)
 - Keep your worldwide estate below \$5.25m (be careful of gift tax if transferring US situs property)
 - Don't increase spouse's estate – Utilization of spousal testamentary trusts
 - Irrevocable life insurance trust (ILIT)
 - Sell US situs assets prior to death
 - Utilize different ownership structures for US situs property

Nonresident Aliens – Estate Tax

Typical ownership strategies utilized for estate planning purposes:

1. Individual ownership

- a) Joint tenancy (right of survivorship)
- b) Tenants in common
- c) Sole ownership

2. Other ownership:

- a) Trust
- b) Corporation
- c) Partnership

Objectives - real property ownership	Single	Joint tenancy	Tenants in common	Trust	Canadian Corporation	Canadian Partnership
Eliminate estate tax exposure:						
- Not US Situs property				X	X	L ⁽²⁾
Minimize estate tax exposure:						
- Marital credit available	X	X	X			
- Avoid double exposure (spouses)	P	P	P			
- Need QDOT or spousal trust	X	X	X			
- Maximization of unified credit	P		P			
- Use poorer spouse (practical)	X					
- Reduction in estate value	P	P	P			
- Each spouse has 50% interest			X			
- Non-recourse mortgage	X	X	X			
Issues and concerns						
- FTC mismatch potential	X	X	X			
- Complex structure				X	X	X
- Additional Canadian filings						
- T-1135	X ⁽³⁾	X ⁽³⁾	X ⁽³⁾	X ⁽³⁾	X ⁽³⁾	X ⁽³⁾
- Canadian corporate T-2					X	
- Trust tax filings				X		
- Shareholder benefits					L ⁽¹⁾	
- Branch tax					X	
- Higher tax rates on capital gains					X	
- FIRPTA requirements	X	X	X	X	X	X
- Potential loss of individual control		X	X	X	P	X
- Potential concerns with legal structure					X	X

P= Planning required

L⁽¹⁾ = Limited planning available - grandfathered single purpose corporations

L⁽²⁾ = Limited planning available - If not in "pursuit of profit", won't be a legal partnership, and many factors to consider in order to properly determine if partnership assets not considered "US Situs" property.

X⁽³⁾ = A T1135 is required to be filed for any "specified Canadian Entity" that has specified foreign property in excess of the threshold. Federal budget 2013 has introduced some changes in relation to Canadian foreign reporting.

Other Issues



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Expatriation

- Applies to U.S. citizens and long-term residents:
 - Permanent resident in at least 8 of last 15 years
- Applies if any of following apply:
 - Average annual net income tax for past five years is $> \$151k$
 - Net worth is $\geq \$2m$ on date of expatriation
 - Fail to certify past five years' tax compliance
- Implications:
 - Mark-to-market on expatriation (similar to CN exit tax)
 - Exemption for first $\$651k$ in gains
 - Donee tax

Voluntary Disclosure

Situation	Compliance Option
Delinquent FBARs, no unreported income	File delinquent FBAR with statement explaining why late. No FBAR penalties.
Delinquent information returns but no tax due	File delinquent information returns (six years) with statement explaining why late. No information return penalties.
Filing Compliance Procedure for Non-resident U.S. Taxpayers (“Streamlined Procedure”)	File delinquent returns (three years) and FBARs (six years) and additional information regarding compliance risk. Pay tax. No penalties for low compliance risk submissions.
2012 Offshore Voluntary Disclosure Program	File eight years filings and account information. Pay offshore penalty of 27.5%/12.5%/5% on undisclosed foreign assets (in lieu of all information reporting penalties).

Questions?



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