TAX PLANNING FOR CANADIANS

Central Arizona Estate Planning Council

October 2, 2017

Brent W. Nelson
SNELL & WILMER L.L.P.
One South Church Avenue
Suite 1500
Tucson, AZ 85701
Phone: (520) 882-1238
Fax: (520) 884-1294
bnelson@swlaw.com

TABLE OF CONTENTS
(continued)

Page

I. CORE CANADIAN TAX CONCEPTS 1
A. Canadian Income Tax 1
B. Canadian Capital Gains 3
C. Life Insurance and Annuities 3
D. Trusts 4
E. Transfer Taxes 4
F. Expatriation and Immigration 4
G. Taxation of Non-Residents 6
II. CORE UNITED STATES INTERNATIONAL TAX CONCEPTS 6
A. International Income Tax 6
B. American Exit Tax 21
C. International Transfer Tax 23
D. Foreign Trusts 33
III. IMPORTANT CANADIAN TREATY PROVISIONS 41
A. Hybrid Entities 41
B. Rent 42
C. Dividends 42
D. Interest 43
E. Royalties 43
F. Capital Gains 44
G. Employment 45
H. Athletes and Artists 45
I. Pensions and Annuities 45
J. Tax Credits 46
K. Non-Discrimination 46
L. Transfer Taxes 46
IV. ISSUES RELATED TO UNITED STATES REVOCABLE TRUSTS 50
A. Taxable Contribution 50
B. Pour-Over Wills 50
C. Alternative Options 50
V. PLANNING FOR AMERICANS WITH CANADIAN CONNECTIONS 51

TABLE OF CONTENTS
(continued)

Page

A. Rental Property in Canada 51

B. Spouses 52

C. Retirement Accounts 53

D. Outbound Investments or Transfers from the United States 56

E. Expatriation 58

F. Repatriation 58

VI. PLANNING FOR CANADIANS WITH AMERICAN CONNECTIONS 58

A. Inbound Investments in or Transfers to the United States—Generally 58

B. Intangible Property 60

C. Tangible Personal Property 60

D. Real Property 61

E. Pre-Immigration Planning 66

F. The United States as a Tax Haven 67

G. Foreign Nongrantor Trusts 68

H. Fixing Pre-Planning Issues 68

VII. COMMON REPORTING ISSUES AND PLANNING 69

A. Silent Disclosures 69

B. Offshore Voluntary Disclosure Program 69

C. Streamline Filing Compliance Procedure 70

D. Delinquent FBAR and International Return Submission Procedures 70

E. Planning Opportunities 71

Brent W. Nelson is a partner at Snell & Wilmer L.L.P., resident in their Tucson, Arizona office. He assists individuals, families, and financial institutions in wealth management matters. He develops custom tax and estate plans for domestic, foreign, and multi-national families and their related entities, with an eye toward global tax efficiency. Brent is a confidant, giving advice on sensitive family and corporate governance issues.

Legal Disclaimer

These materials are by no means a substitute for careful tax and legal planning and the recipient of these materials is strongly encouraged to consult with a tax and legal professional familiar with these rules and the recipient's particular situation. These materials are meant as a general introduction of the topics included and are not meant as an exhaustive representation of each topic or all issues related to each topic. Each person in possession of these materials should conduct his or her own independent research of each topic covered in the materials or he or she should seek his or her own independent legal counsel, and he or she should not rely on these materials independently. These materials are not meant as a tax opinion or to be used to avoid tax penalties.

These materials are not meant to and do not create an attorney-client relationship between the author and the materials' recipient. The content of these materials are not legal advice and should not be considered legal advice or opinion, because the content may not apply to the specific facts of a particular matter. If the recipient of these materials needs legal advice, he or she should seek the advice of an attorney practicing in his or her jurisdiction.

TAX PLANNING FOR CANADIANS

By: Brent W. Nelson
Snell & Wilmer L.L.P.

Tax planning for international clients with ties to Canada (both inbound and outbound) begins with an understanding of certain basic concepts of international income and transfer taxation under Canadian and United States laws. Section I will focus on these core concepts in a general sense as they relate to Canada. Section II will focus on these core concepts in a general sense as they relate to the United States. Section III then discusses special provisions under the Canadian Treaty. Section IV will cover special issues in Canada with regard to United States revocable trusts. Sections V, VI, and VII will then discuss common income and transfer tax problems and planning. This outline is not meant to be exhaustive, but only an introduction. This outline focuses exclusively on the taxation of individuals, unless it expressly provides otherwise.

I. CORE CANADIAN TAX CONCEPTS. The author is **not** a Canadian attorney and the discussion of Canadian laws in these materials is **not** meant as advice related to Canadian law. The author's recitation of any Canadian laws is strictly based on the explanation of Canadian law found in the following sources:

- Goodman et. al., "Special Considerations in U.S.-Canada Estate Planning," in *A Guide to International Estate Planning*, 575–99 (Basha ed. 2014).
- Goodman, "Cross-Border Estate Planning: The Canada-United States Income Tax Convention," *Prob. & Prop.* 45–53 (July/Aug. 1996).
- Patrick Marley and Sue Wooles, "Business Operations in Canada," 7050-1st Tax Mgmt. (BNA) Foreign Income.
- Technical Explanation to the Canadian Treaty (defined below).
- Canada Revenue Agency Income Tax Folio S5-F1-C1, *Determining an Individual's Residence Status* (March 2013, revised April 2016).
- Canada Revenue Agency Guide T4058, *Non-Residents and Income Tax*.
- Canada Revenue Agency, *Types of Trusts*, http://www.cra-arc.gc.ca/tx/trsts/typs-eng.html.
- Canada Revenue Agency Interpretive Bulletin IT-209R, *Inter-vivos Gifts of Capital Property to Individuals Directly or Through Trusts*.

A. Canadian Income Tax. Canada taxes the worldwide income and capital gains of all "residents" of Canada. If an individual is not a resident, then he or she is a "non-resident" of Canada and is taxed in Canada on his or her Canada source income or capital gains.

1. **Residency in General.** An individual is a resident of Canada if the individual is "ordinarily resident" in Canada. If the individual is not ordinarily resident, then he or she may also be a "deemed resident." Both are discussed below.

2. **Ordinarily Resident.** An individual is ordinarily resident under a facts and circumstances domicile-type test. In *Thomson v. M.N.R.*, 2 D.T.C. 812 (SCC 1946) the Supreme Court of Canada enumerate three principles to determine whether one is ordinarily resident: (i) every person at all times has a residence, (ii) a person may be a resident in more than one country at the same time, and (iii) the intention of the person is relevant but not determinative. The Canadian Courts have looked to the following factors to apply these principles: past and present habits of life, regularity and length of visits in the jurisdiction asserting residence, ties within that jurisdiction, ties elsewhere, and permanence or purpose of stay abroad. The Canadian Revenue Agency ("CRA") views whether an individual maintains ties with Canada to be the most important factor, and further views as most important a spouse or common law partner in Canada, dependents located in Canada, and a residential dwelling in Canada.

3. **Deemed Resident.** An individual is deemed resident if he or she sojourned in Canada for a period or periods during the tax year of **183 days or more**. CRA and Canadian Court's interpret "sojourn" as temporary presence. Thus, being present in Canada for 183 days in a tax year will make an individual deemed resident.

4. **Deemed Non-Resident (Treaty Tied-Breaker).** Even if an individual is a resident under the rules above, he or she can be deemed a non-resident under the tie-breaker rules of the Income Tax Convention between Canada and the United States, a so called "Treaty Tie-Breaker." *See* Convention With Respect to Taxes on Income and on Capital, U.S.-Can. Sept. 26, 1980, as amended by Protocols on June 14, 1983, March 28, 1984, March 17, 1985, July 29, 1997, and Sept. 21, 2007 ("Canadian Treaty"), Art. IV. Under Article IV(2) of the Canadian Treaty, if an individual is a resident of both Canada and the United States the individual will be treated as a resident of the country where one of the following (in the order listed) applies:

   i. Where there is a permanent home available to him or her.

   ii. Where his or her center of vital interests are located (if the individual has a permanent home in both countries).

   iii. Where his or her habitual abode is located (if he or she has no permanent home in either country and his or her center of vital interests cannot be determined).

iv. Where he or she is a citizen (if the individual has a habitual abode in both countries).

v. As the tax authorities in the two countries determine (if the individual is a citizen of both countries or neither of them).

B. Canadian Capital Gains. Capital gains are taxed in Canada by including in income 50% of the amount realized (except 100% of any depreciation recapture is included in income).

1. **Gifts.** Generally, Canada treats inter vivos gifts (including transfers into trusts) as deemed realization events at fair market value. Gifts to the donor's spouse are excluded from this treatment, as are gifts to a trust for the donor's spouse's exclusive benefit during his or her lifetime. Gifts of farm or fishing businesses are also excluded. In any case where a deemed realization is excluded, the capital gains realization is effectively deferred until the property is disposed of at a future date.

2. **Death.** Generally, Canada treats property held at death as being disposed of at fair market value as of the date of death. There are similar exceptions to this result as apply to gifts.

3. **Trusts.** Generally, Canada treats trust property as being disposed of at fair market value every twenty-one years (the "21-Year Rule"), with limited exceptions. The 21-Year Rule does not apply to trusts for the exclusive benefit of a spouse (in which case the property is deemed to be disposed of at fair market value on the spouse's death). The 21-Year Rule also does not apply to trusts created after 1999 by someone aged 65 or older, for his or her exclusive benefit or the exclusive benefit of him or her and his or her spouse (with deemed realization events at the settlor's death or the second spouse's death, respectively). Other exceptions to the 21-Year Rule may also apply but they are beyond the scope of this outline.

C. Life Insurance and Annuities.

1. **Life Insurance.** Although the proceeds from a life insurance policy are not included in capital gains, the growth in a cash value policy is taxed in Canada each year unless the policy qualifies as an "exempt policy." An exempt policy is defined in Regulation 306, but essentially is a level premium 20-pay endowment-at-85 policy that does not exceed certain increases in the face amount annually. A single premium life insurance policy does not typically qualify as an exempt policy. Exempt policies permit tax deferral until they are surrendered.

2. **Annuities.** Generally, Canada requires annual taxation of all investment growth in investment contracts, including annuities. This does not apply to a "prescribed annuity contract." A prescribed annuity contracts is an immediate annuity, that is owned by an individual, and that provides level

payments. The annuity payments on prescribed annuity contracts are taxed in Canada, but the recipient receives a deduction for the return of capital component of the payment.

D. **Trusts.** Canada treats trusts as separate taxpayers from the trustee and beneficiaries, and thus trusts are generally taxed in the same manner as individuals. A trust is resident in Canada if its central management and control are in Canada. When the trust distributes income to its beneficiaries, the trust is permitted a deduction for the distributed income and the beneficiary becomes liable for the tax on that income. As mentioned above, trusts are also subject to the 21-Year Rule.

1. **Distributions of Property.** Distributions in kind in satisfaction of an income interest in a trust are treated as taxable dispositions of the property at fair market value. Distributions in kind in satisfaction of a capital interest in a trust may qualify for roll-over treatment, deferring tax on any built-in gain in the property until the beneficiary disposes of the property in the future. A beneficiary receiving roll-over property takes a carry-over basis in the property and is not permitted to take a loss as to any losses that accrued while the trust owned the property.

2. **Tax Rate.** Testamentary trusts are taxed at progressive tax rates for the first 36 months of their existence, then at the highest marginal tax rate. Inter vivos trusts are taxed at the highest marginal tax rate.

3. **Non-resident Beneficiary.** Generally, distributions to non-resident beneficiaries subjects the trust to a 36% tax on the deduction amount it takes on the distributed "designated income." Designated income includes capital gains from disposing of "Taxable Canadian Property" (defined below), income from Canadian real property, income from Canadian timber resource property or Canadian resource property, and business income from Canada.

E. **Transfer Taxes.** Canada does not have transfer taxes similar to the United States Federal Estate Tax, Gift Tax, or Generation-Skipping Transfer Tax ("GST Tax"). Instead, the Canadian capital gains tax applies to inter vivos gifts and at death. The 21-Year Rule also substitutes as a kind of GST Tax in that it prevents trusts from accumulating untaxed property.

F. **Expatriation and Immigration.** Canada has special rules related to individuals who cease to be residents and non-residents who become residents in Canada.

1. **Expatriates.** When a Canadian resident ceases to be resident in Canada he or she is deemed to have disposed of certain of his or her worldwide property (the "Canadian Exit Tax"). The Canadian Exit Tax does not apply to Canadian real property and certain rights to receive future income (including RRSP and RRIF accounts (*see* Section V(C)(1) below)).

Certain amounts of capital loss can offset the Canadian Exit Tax. The Canadian Exit Tax can be postponed if the individual posts security to CRA, in which case the Canadian Exit Tax is paid when the property is sold in the future, without interest.

2. **Immigrants.** Generally, when a non-resident individual becomes a Canadian resident, he or she is deemed to have disposed of all of his or her worldwide assets for fair market value (meaning the immigrant receives a new basis (up or down) in the property). This does not apply to "Taxable Canadian Property," inventory in a business carried on in Canada, certain capital property in respect of a business carried on in Canada, and an "excluded right or interest" other than an interests in a non-testamentary trust that was not acquired for consideration. Taxable Canadian Property means any of the following:

    i. Real or immovable property located in Canada.

    ii. Property used or held in a business carried on in Canada.

    iii. Designated insurance property belonging to an insurer.

    iv. Shares of corporations not listed on a designated stock exchange, an interest in a partnership, or an interest in a trust, if at any time in the previous 60 month period, more than 50% of the fair market value of the shares or interest was derived from one or any combination of:

        a. Real or immovable property located in Canada;

        b. Canadian resource property;

        c. Canadian timber resource property; and

        d. Options or interests in any of the above.

    v. Shares of corporations listed on a designated stock exchange, a share of a mutual fund corporation or unit of a mutual fund trust, if at any time in the previous 60 month period:

        a. 25% or more of the issued shares of any class, or 25% or more of the issued units, belonged to any combination of the taxpayer or persons with whom the taxpayer did not deal with at arm's length or partnerships in which the taxpayer or persons with whom the taxpayer did not deal with at arm's length holds a membership interest directly or indirectly through one or more partnerships; and

b. More than 50% of the fair market value of the shares or unit was derived from one or any combination of:

(a) Real or immovable property located in Canada;

(b) Canadian resource property;

(c) Canadian timber resource property; and

(d) Options or interests in any of the above.

vi. An option or interest in any property listed above.

G. Taxation of Non-Residents. Canada taxes non-residents on Canadian source income and capital gains. These categories of income are taxed under one of two methods. Method 1 requires payors of passive-type income payments and retirement payments to withhold a 25% tax (on a gross basis) and to remit the tax to CRA. Income subject to withholding includes interest, dividends, rent, pension payments, old age security payments, Canadian Pension Plan and Quebec Pension Plan benefits, retiring allowances, RRSP payments (*see* Section V(C)(1) below), pooled registered pension plan payments, RRIF payments (*see* Section V(C)(1) below), annuity payments, and royalties. Method 2 requires the non-resident to file a Canadian tax return reporting the income and paying the tax (on a net basis) to CRA. Income subject to reporting includes income from Canadian employment, income from a business carried on in Canada, the taxable portion of Canadian scholarships, fellowships, bursaries, and research grants, or capital gains from the disposition of Taxable Canadian Property. The Canadian Treaty may alter some of these results (as discussed below). The non-resident may make certain elections under Canadian law that alter these results, allowing the non-resident to report and pay tax on a net basis on certain Canadian income (including rental income on Canadian real property or immovable property).

II. CORE UNITED STATES INTERNATIONAL TAX CONCEPTS.

A. International Income Tax. International income taxation in the United States depends on the categorization of the individual as a citizen, a resident, or a non-resident alien ("NRA").

1. **Citizenship.** Although the concept of citizenship in the United States seems simple, in practice it is not. A "citizen," generally speaking, is a person born or naturalized in the United States and subject to United States laws. 8 U.S.C. §1401. Thus, if a person is born in the United States to parents who are diplomats in the United States, that person is not automatically a citizen because he or she would not have been subject to United States laws. Beyond that, the rules are more complicated. Thus, the statute (8 U.S.C. §1401) provides that the following individuals born outside of the United States are also citizens:

- An individual born of parents, both of whom are citizens of the United States and one of whom has had a residence in the United States or in its outlying possessions prior to the birth of the individual.

- An individual born of parents, one of whom is a citizen of the United States who has been physically present in the United States or one of its outlying possessions for a continuous period of one year prior to the birth of the individual, and the other of whom is a national, but not a citizen of the United States.

- An individual born in an outlying possession of the United States of parents one of whom is a citizen of the United States who has been physically present in the United States or one of its outlying possessions for a continuous period of one year at any time prior to the birth of the individual.

- An individual of unknown parentage found in the United States while under the age of five, until shown, prior to his or her attaining the age of twenty-one, not to have been born in the United States.

- An individual born of parents one of whom is an alien, and the other a citizen of the United States who, prior to the birth of such person, was physically present in the United States or its outlying possessions for a period or periods totaling not less than five years, at least two of which were after attaining the age of fourteen. Physical presence in the United States includes honorable service abroad in the United States military, with the United States government, or certain international organizations, or time as the unmarried child of an individual serving with those organizations.

- An individual born before noon (Eastern Standard Time) May 24, 1934, outside the limits and jurisdiction of the United States of an alien father and a mother who is a citizen of the United States who, prior to the birth of the individual, had resided in the United States.

Thus an individual may not even know that he or she is a citizen, because he or she may fit into one of the provisions relating to individuals born abroad. An individual born aboard may be a citizen of another country, may have a passport from another country, and may have never been in the United States, and yet he or she is no less a citizen. As is discussed in further detail below, being a citizen has significant United States tax implications.

2. **Residents.** For **income tax purposes**, a non-citizen is a "resident" of the United States if he or she is a lawful permanent resident of the United States at any time during the year, he or she fails the Substantial Presence Test during the year, or he or she makes an election to be taxed as a

resident. I.R.C. §7701(b)(1)(A). Any non-citizen who is not a resident is a non-resident alien ("NRA"). I.R.C. §7701(b)(1)(B).

i. Lawful Permanent Residence. A lawful permanent resident is a person holding a visa entitling him or her to permanent residence and the ability to work in the United States (colloquially called a "green card"). *See* I.R.C. §7701(b); Treas. Reg. §301.7701(b)-1(b)(1). The status as a lawful permanent resident continues until it is rescinded or administratively or judicially determined to have been abandoned. Treas. Reg. §301.7701(b)-1(b)(1). Therefore, the actual residence of the lawful permanent resident is irrelevant, as is the fact that he or she may be violating his or her visa (at least until it is rescinded or abandoned). *See id.*

a. *Voluntary Abandonment of Green Card.* A lawful permanent resident may voluntarily abandon his or her green card by commencing a judicial proceeding or filing an application for abandonment (INS Form I-407) or sending a letter to INS or a consular office stating his or her intent to abandon his or her green card with an Alien Registration Receipt Card (INS Form I-151 or Form I-551). Treas. Reg. §301.7701(b)-1(b)(3).

b. *Involuntary Abandonment of Green Card.* A green card may be involuntarily abandoned if INS or a consular officer initiates an administrative or judicial proceeding to do so and the proceeding concludes in the United State government's favor. *See id.*

ii. Substantial Presence Test. An NRA becomes a resident if he or she fails the Substantial Presence Test. An individual fails the Substantial Presence Test if the individual is in the United States for 31 or more days in the current year, and for 183 or more days, in the aggregate, in the current year and the two preceding years. I.R.C. §7701(b)(3). To calculate the 183 days, all days in the current year are counted, one third of the days in the first preceding year are counted, and one sixth of the days in the second preceding year are counted. *Id.*

a. **For example**, if an individual was in the United States 120 days each year for three consecutive years, he or she did not fail the Substantial Presence Test as follows: 120 days (Year 1) + 40 [1/3 x 120] (Year 2) + 20 [1/6 x 120] (Year 3) = 180.

b. **If, instead**, the individual was in the United States 122 days each year for three consecutive years, he or she did

fail the Substantial Presence Test as follows: 122 (Year 1) + 40.67 [1/3 x 122] (Year 2) + 20.33 [1/6 x 122] (Year 3) = 183.

c. *Counting Days*. Any day the individual is physically in the United States (regardless of how long) is counted, other than days in the United States while in transit between two points outside of the United States, days in the United States while prevented from leaving due to illness arising while in the United States, or days in the United States while serving as a foreign government or organization employee, diplomat, or consular, as a teacher or student (holding certain visas and for up to two years), or as a professional athlete competing in a charitable event. *Id.*; Treas. Reg. §301.7701(b)-1(c)(2), -3(b). Presence for any portion of a day is counted as a full day.

d. *Exception for Commuting Canadians and Mexicans*. An NRA who regularly commutes to the United States from his or her residence in Canada or Mexico does not need to count the days spent commuting to the United States in his or her Substantial Presence Test calculation. Treas. Reg. §301.7701(b)-3(e)(1). "Commuting" means travel to employment (or self-employment) and returning to one's residence within a 24-hour period. Treas. Reg. §301.7701-3(e)(2)(i). It is commuting only if the NRA commutes to the United States for work on more than 75% of the workdays (meanings days worked in the United States) during the working period (meaning the period beginning on the first day the NRA works in the United States and ending n the last day the NRA works in the United States). Treas. Reg. §301.7701(b)-3(e)(1), (2)(ii) & (iii).

e. **<u>For Example</u>**: Hank is a Canadian citizen and resident living in Vancouver, B.C. and commuting for work to Bellingham, WA for part-time work 100 days out of the year. Hank also has a second home in Rio Rico, AZ. Hank holds a Visa that entitles him to travel to the United States but is not a permanent resident visa. Hank lives in Rio Rico 100 days in Year 1, 155 day in Year 2, and 179 days in Year 3. He also traveled to Seattle, WA for a 3-day weekend get away in Year 1. Hank fails the Substantial Presence Test. Ignoring his commuter days, he was in the United States: 103 days (Year 1) + 51.67 days (Year 2) + 29.83 days (Year 3) = 184.5 days. In Year 3 (unless an exception below applies) Hank is United States resident taxable in the United States on his worldwide income, **<u>even</u>**

though he never violated his Visa or immigrated to the United States.

iii. Exceptions to Substantial Presence Test: Closer Connection or Treaty Tie-Breaker. If a Canadian fails the Substantial Presence Test, he or she may still qualify as an NRA in the United States if either (1) he or she can establish a closer connection to Canada ("Closer Connection Test"), Treas. Reg. §301.7701(b)-2(a), or (2) he or she is a resident of both the United States and Canada and he or she is treated as an NRA in the United States under the Treaty Tie-Breaker. *See* Canadian Treaty, Art. IV(2).

a. *Closer Connection Test*. A Canadian may pass the Closer Connection Test, and be an NRA, if he or she is in the United States for less than 183 days in the current year, he or she maintains a tax home in Canada, and he or she has a closer connection in Canada (where his or her tax home is located) or in two foreign countries. Treas. Reg. §301.7701(b)-2(a). A "tax home" is the location of the individual's regular or principal place of business, and if the individual has none, then the individual's regular place of abode in a real and substantial sense. Treas. Reg. §301.7701(b)-2(c)(1). A "closer connection" is determined by all of the facts and circumstances. The factors used to determine a closer connection include the location of the individual's: permanent home; personal belongings; family, social, political, cultural, and religious relationships; personal banking; business activities; driver's license; and voter registration and voting. Treas. Reg. §301.7701(b)-2(d)(1). Also material are the residence the individual indicates on forms and documents and the types of official forms the individual files. *See id.* In order to claim a closer connection, the individual **must file a timely Form 8840 each year that the closer connection is claimed**. *See* Treas. Reg. §301.7701(b)-8(a)(1), -8(b)(1)(i); Instructions to Form 8840.

b. Treaty-Tie Breaker. The Treaty Tie-Breaker rules of the Canadian Treaty are discussed in Section I(A)(4) above. If a Canadian is claiming to be a resident of Canada under the Treaty Tie-Breaker, then he or she **must file a timely United States income tax return with a Form 8833 each year that the Treaty Tie-Breaker is claimed**. *See* I.R.C. §6114(a); Treas. Reg. §§301.6114-1(d)(1), 301.7701(b)-7(b), (c); Instructions to Form 8833. Failure to disclose the treaty position in this fashion can expose the Canadian to a $1,000 penalty ($10,000 for C corporations) per failure to

disclose, meaning per treaty position the Canadian failed to report in the year. I.R.C. §6712(a); Treas. Reg. §1.6712-1(a). The penalty can be waived if the failure to report was not due to "willful neglect." Treas. Reg. §1.6712-1(b). A cautious approach would be to have the NRA file a timely income tax return and Forms 8840 and 8833 each year, to hedge against the possibility that the IRS could determine the NRA does not meet one of those two tests.

3. **NRAs.** An NRA is any person who is not a citizen or resident of the United States. I.R.C. §7701(b)(1)(B).

4. **Income Taxation of Citizens and Residents.** The United States system of taxation is territorial as to NRAs. The United States system of taxation is residential as to United States residents. And the United States system of taxation is based on citizenship as to United States citizens. Taxation based on citizenship is rare in the world. In fact, only one other country—Eritrea—has a system of taxation based on citizenship. Since citizens and residents of the United States are treated the same for income tax purposes in the United States, they are both referred to as residents in the balance of this outline, unless otherwise indicated.

   i. Residents. **Residents are taxed on their worldwide income (absent a saving provision in a treaty).** *See* I.R.C. §§1(a)–(c), 61(a), 877(a). Generally, the United States reserves the right to tax its citizens in income tax treaties, but it did not do so in the Canadian Treaty. *See* Canadian Treaty, Art. I. A resident is taxed on all investment income, such as interest, dividends, and capital gains, and on his worldwide salary and compensation. *See* I.R.C. §61(a). A resident is also taxed on his or her share of tax items of any partnerships or S corporations. *See* I.R.C. §§61(a), 702(a), 1366(a). Finally, a resident is taxed under special anti-deferral taxing regimes related to foreign corporations and foreign trusts, each discussed below. If a resident has income from foreign sources, in order to avoid double taxation, a credit may be available against any foreign income taxes paid. *See* I.R.C. §§901–09; Canadian Treaty, Art. XXIV.

   ii. Net Investment Income Tax. The net investment income tax (the 3.8% Medicare surtax) does not apply to NRAs or to residents who are treated as NRAs under a Treaty Tied-Breaker. Treas. Reg. §1.1411-2(a)(1), (2)(i), (2)(ii). If an individual is a resident for part of the year and an NRA for part of the year, then the net investment income tax applies to the part of the year in which he or she was a resident. Treas. Reg. §1.1411-2(a)(2)(ii). If an NRA and a United States resident are married and file jointly, then the couple are treated as filing separately for net investment income

tax purposes, unless they elect to combine their income for purposes of the net investment income tax. Treas. Reg. §1.1411-2(a)(2)(iii). If an NRA and a United States resident are married and file jointly, and the NRA becomes a resident during the year, then the couple are treated as filing separately and the NRA spouse is taxed on his or her net investment income only for the portion of the year in which he or she was a resident, unless they elect to combine their incomes. Treas. Reg. §1.1411-2(a)(2)(iv).

iii. Interests in Business Entities. Residents are subject to special anti-deferral tax rules related to their interests in foreign business entities. The special tax rules depend on the category of the business entity under United States tax law. Each category has its own special rules. The three categories are: (1) corporations, (2) disregarded entities, or (3) partnerships.

a. *Corporations*. To identify the correct category, the tax rules sort business entities into two groups: those that are always corporations and those that may elect to be a different category. Certain foreign business entities are automatically treated as corporations (including, for example, a Canadian Corporation and Company) ("Automatic Corporations"). Treas. Reg. §301.7701-2(b)(8). Any business entities that are not Automatic Corporations may elect to be treated in the United States as a disregarded entity (if the entity has only one member) or as a partnership or corporation (if the entity has more than one member). Treas. Reg. §301.7701-3(a). Entities (that are not Automatic Corporations) that by default are not disregarded entities or partnerships are categorized as corporations. Treas. Reg. §301.7701-3(b)(2)(i)(B). A disregarded entity or a partnership may elect to be treated as a corporation. Treas. Reg. §301.7701-3(c)(1)(i). An election to be taxed as a corporation is treated as a contribution of all of the electing entity's assets to a corporation immediately followed by a liquidation of the electing entity by distributing the corporation's stock to the members. *See* Treas. Reg. §301.7701-3(g)(1)(i), (iv).

b. *Disregarded Entities*. Entities (that are not Automatic Corporations) that have a single owner who is not protected from the liabilities of the entity are by default categorized as disregarded entities. Treas. Reg. §301.7701-3(b)(2)(i)(C). Disregarded entities may also be entities with a single member who makes an election to treat the entity as a disregarded entity. Treas. Reg. §301.7701-3(c)(1)(i). A disregarded entity is also formed when an

entity previously classified as a partnership ceases to have more than one member. Treas. Reg. §301.7701-3(f)(2). An election to treat an entity as a disregarded entity is a deemed liquidation of the electing entity. Treas. Reg. §301.7701-3(g)(1)(iii). If the entity (including foreign entities) is a disregarded entity, then it is ignored for United States income tax purposes and a resident owner is instead taxed in the United States on the entity's income as if he or she received it directly. *See* Treas. Reg. §301.7701-2(a).

c. *Partnerships*. Entities (that are not Automatic Corporations) that have at least two owners and at least one owner is not shielded from the entity's liabilities are by default categorized as partnerships. Treas. Reg. §301.7701-3(b)(2)(i)(A). In addition, entities with at least two owners that would be corporations (for example, because all members are shielded from liability) may elect to be treated as partnerships. Treas. Reg. §301.7701-3(c)(1)(i). An election to treat an entity as a partnership is treated as a liquidation of the electing entity by a distribution of all of the entity's assets and liabilities to the members immediately followed by the members' contribution of the assets and liabilities to a partnership. Treas. Reg. §301.7701-3(g)(1)(ii). A resident who is a partner in a partnership (including a foreign partnership) is taxed in the United States on his or her share of the partnership's income, expenses, deductions, and credits. I.R.C. §702(a). This includes the resident's share of foreign taxes paid by the partnership, which may generate a credit in the United States to avoid double taxation. *See* I.R.C. §§702(a), 901–09; Canadian Treaty, Art. XXIV.

iv. <u>Special Rules Regarding Foreign Corporations</u>. Typically, a corporation (other than an S Corporation) pays tax on its income. I.R.C. §§11(a), 1366(a). Typically, foreign corporations only pay tax in the United States on their United States source income. I.R.C. §§881(a), 882(a), 897(a). A resident shareholder of a foreign corporation would therefore not ordinarily be taxed on the foreign corporation's income unless the corporation made a distribution (such as a dividend) to the shareholder, I.R.C. §301(a), or unless the foreign corporation was either a controlled foreign corporation ("<u>CFC</u>") or a passive foreign investment company ("<u>PFIC</u>"). I.R.C. §§951(a), 1291(c)(2)(B), 1293(a). Special anti-deferral tax rules related to CFCs and PFICs can prevent the deferral of tax on the foreign corporation's foreign earnings or tax later distributions (or dispositions of the stock) disadvantageously for any resident shareholders.

a. *CFCs*. A CFC is a foreign corporation in which **greater than 50% (by vote or value) of the corporation's stock is owned by United States shareholders**. I.R.C. §957(a). United States shareholders are only those shareholders who are United States citizens or residents who **own at least a 10% interest in the voting stock** of the corporation. I.R.C. §951(b). Ownership of stock is either direct ownership, or indirect ownership through members of the shareholder's family, partnerships, corporations, trusts, or estate. I.R.C. §958. If the corporation qualifies as a CFC for at least 30 days during the year, then the special anti-deferral tax rules apply. *See* I.R.C. §951(a).

(a) The anti-deferral tax rules provide that if a CFC is engaged in a foreign trade or business, then a resident shareholder is not taxed on the CFC's income from that foreign trade or business if the corporation does not make a distribution to the shareholder. I.R.C. §§301, 951(a). The resident shareholder may be taxed at ordinary income tax rates on the resident shareholder's share of the CFC's income in certain special circumstances, however, regardless of whether the CFC made a distribution, including, (1) if the CFC's earns income from passive sources and (2) if the CFC owns interests in property located within the United States (called "Subpart F" income). I.R.C. §§951(a), 956(a).

(b) In addition, if the resident shareholder sells his or her interest in the CFC after holding a 10% voting interest in the CFC at any time in the five years before the sale, then the resident shareholder is treated as receiving a dividend equal to his or her share of the CFC's earnings and profits while he or she held the interest in the CFC (referred to as "1248 gain"). I.R.C. §1248(a).

b. *PFICs*. A foreign corporation is a PFICs if (1) **at least 75% of the corporation's gross income** is passive or (2) on average **at least 50% of the corporation's assets** produce passive income. I.R.C. §1297(a). For example, most foreign mutual funds are PFICs. Any interest a resident has in a PFIC is subject to special tax rules, regardless of the size of the interest. *See id*.

(a) The special tax rules for PFIC provide that, unlike a CFC, a resident shareholder may choose his or her tax treatment. The default rule is that the resident may defer paying tax on the PFIC's income unless the PFIC makes certain distributions to the resident (called "Excess Distributions") or the resident sells his or her interest in the PFIC. I.R.C. §1291(a). An Excess Distribution is a distribution that exceeds 125% of the average of distributions the resident received in the three preceding tax years. I.R.C. §1291(b). There is no Excess Distribution in the first year of the resident's holding period. I.R.C. §1291(b)(2)(B). In either of those scenarios (an Excess Distribution or a sale), the resident is taxed, at ordinary income tax rates, on the distribution or gain on the sale, and the Excess Distribution or gain is allocated ratably to each day of the resident's holding period and is charged interest on that amount proportionately for all years the resident held the PFIC stock. I.R.C. §1291(a). A resident may elect out of the default rule by either (1) electing to treat the PFIC as a qualified electing fund ("QEF") or (2) electing to recognize income from the PFIC on mark-to-market basis ("MTM"). I.R.C. §§1293, 1296.

(b) If a resident makes a QEF election, then each year he or she must pay ordinary income tax on his or her share of any ordinary income earnings of the PFIC (being anything other than the PFIC's capital gains) and long-term capital gains tax on his or her share of any capital gains of the PFIC. I.R.C. §1293(a). In addition, if a QEF election is made, distributions from sources already taxed to the resident are not taxable and the resident receives an increase in his or her basis in the PFIC for his or her annual share of income and capital gains of the PFIC. I.R.C. §1293(c), (d). If a QEF election is made, and the resident sells his or her interest in the PFIC, then he or she must recognize capital gain to the extent the amount received in the sale exceeds his or her basis in the PFIC. I.R.C. §1291(d)(1). If a QEF election is made after the first year the corporation was a PFIC, then the resident would continue to be taxed under the normal default PFIC rules, unless he or she elects to be treated as having sold the PFIC stock on the first day of the QEF

election. *See* I.R.C. §§1291(d)(2)(A). Similarly, once a corporation is a PFIC as to a shareholder it would always be a PFIC to that shareholder unless the shareholder elects to be treated as selling his or her shares on the last day the foreign corporation was a PFIC. *See* I.R.C. §1298(b)(1). The QEF election is made on a Form 8621 that is filed with a timely income tax return. Treas. Reg. §1.1295-1(f).

(c) The MTM election is allowed for PFICs that are regularly traded on a securities exchange. I.R.C. §1296(a). Under the MTM election, the resident recognizes ordinary income each year if the fair market value of his or her interest in the PFIC at the close of the tax year exceeds his or her basis in the PFIC, and receives a deduction if the fair market value of his or her interest in the PFIC at the close of the tax year is less than his or her basis in the PFIC. *Id.* If an MTM election is made and the resident sells his or her interest in the PFIC, then he or she recognizes ordinary income or loss on any gain or loss from the sale. I.R.C. §1296(c)(1). An MTM election is made on a Form 8621 filed with a timely income tax return. Treas. Reg. §1.1296-1(h)(1)(i).

(d) If a foreign corporation could be either a CFC or a PFIC, then it is treated as a CFC. I.R.C. §1297(d).

v. Foreign Information Returns. Any United States resident (either as a citizen, lawful permanent resident, electing resident status, or failing the Substantial Presence Test), and often regardless of any Treaty Tie-Breaker that might treat him or her as an NRA, is required to make extensive and wide ranging annual disclosures to the United States government in each year that he or she is a resident. *See e.g.* Treas. Reg. §301.6114-1(a) (stating treaty-based positions effect positions that reduce tax, but not specifying reducing disclosure requirements); Treas. Reg. §301.7701(b)-7(a)(3) (stating that other than Code provisions related to computing income tax liability, a duel resident taxpayer is treated as a resident of the United States even if a Treaty Tie-Breaker applies); *see also* 31 CFR 1010.350(b) (defining residency for FBAR purposes without a clear statement that a Treaty Tie-Breaker would change residency); *contra* Treas. Reg. §1.6036D-1(a)(3) and T.D. 9706 (12/12/2014) (providing that for Form 8938 purposes a Treaty Tie-Breaker can be used to determine residency). Failure to make the disclosures generally exposes the

resident to significant civil and criminal penalties. The Minimum civil penalty per violation is typically $10,000. Additionally, failure to file a required foreign information return can cause the statute of limitations on the income tax return to remain open until the resident files the foreign information return. I.R.C. §6501(c)(8)(A). The foreign information return requirements are extensive, duplicative, and onerous. A complete explanation of the requirements is beyond the scope of these materials. However, a sample of the forms a resident with foreign financial interests or foreign-source income, gifts, or bequests might need to file, includes:

a. FinCEN Form 114 (Foreign Bank Account Report).

b. Form 8938 (Statement of Specified Foreign Financial Assets).

c. Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts).

d. Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner).

e. Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations).

f. Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business).

g. Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation).

h. Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund).

i. Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships).

5. **Income Taxation of NRAs.** In contract to a resident, an NRA is generally taxed in the United States on his or her (1) income effectively connected with a trade or business, or the performance of personal services, within the United States ("ECI"), or (2) fixed or determinable annual or periodic income from sources within the United States ("FDAP"). I.R.C. §871(a) & (b). If the NRA has both ECI and FDAP in one year, then the NRA's income is classified into those two categories and each category is taxed separately. Treas. Reg. §1.871-8(a). The

United States does not generally tax the NRA on income from other sources, including outside the United States.

i. ECI. Whether income is ECI income is purely a question of the United States' tax laws, and not the laws of any foreign jurisdiction. Treas. Reg. §1.864-3(a). **Income can be ECI by definition, by election, or by default.** ECI is taxed at ordinary income rates in the United States, and ECI is subject to available deductions and credits (such as deductions for costs incurred in the generation of income). Consequently, ECI is taxed on a net basis (net of deductions and credits). I.R.C. §§871(b)(2), 872–874. ECI is not subject to the net investment income tax. *See* Treas. Reg. §1.1411-2(a)(1).

a. *Definition*. All income from sources within the United States is ECI, other than income from the sale or exchange of a capital asset (subject to the special rules below) or FDAP (subject to special rules below). Treas. Reg. §1.864-4(a). That is, even if the income is not in fact connected with the conduct of a trade or business in the United States, it would be treated as ECI by definition if it is neither a capital gain nor FDAP. Treas. Reg. §1.864-4(b).

(a) Generally, capital gains from sources within the United States are not taxed to an NRA that was not in the United States for more than 182 days in the year of the sale and the year of collection. I.R.C. §871(a)(2).

(b) Capital gains or FDAP, however, may be taxed as ECI if the gains or FDAP income are either derived from assets used in, or held for use in, the conduct of a trade or business in the United States (the so called "asset-use test") or if the activities of the trade or business conducted in the United States were a material factor in the realization of the gains or FDAP income (the so called "business-activities test"). Treas. Reg. §1.864-4(c)(1)(i), (c)(2), (c)(3).

b. *Election*. **An NRA may elect to treat non-ECI income from real property as ECI.** The NRA may make an election under I.R.C. §871(d) ("871(d) Election"). A similar election is available to foreign corporations. *See* I.R.C. §882(d). Making the 871(d) Election causes the income from the real property to be included in, and taxed with, the NRA's ECI, instead of being subject to the tax on FDAP (discussed below). Since FDAP is taxed on a gross

basis, and ECI is taxed on a net basis, this can reduce the rate of taxation. Also, non-partnership ECI is not typically subject to withholdings, while FDAP is subject to withholdings. Thus, an 871(d) Election can relieve an NRA landlord's tenant from the withholding requirements that apply to FDAP.

(a) The 871(d) Election is made by attaching a statement to the NRA's return, or amended return, for the year of the election. The statement must include the following:

- That the NRA is making the election.
- Whether the choice is under I.R.C. §891(d) or a tax treaty.
- A complete list of all of the NRA's real property, or any interest in real property, located in the United States, including the legal identification of U.S. timber, coal, or iron ore in which the NRA has an interest.
- The extent of the NRA's ownership in the property.
- The location of the property.
- A description of any major improvements to the property.
- The dates the NRA owned the property.
- The NRA's income from the property.
- Details of any previous choices and revocations of the real property income choice.

See Treas. Reg. §1.871-10(d); IRS Publication 519.

(b) If the NRA makes the 871(d) Election, then the NRA provides the tenant with a W-8ECI to indicate that the tenant does not need to withhold the FDAP taxes. Treas. Reg. §§1.871-10(d)(1)(iii), 1.1441-4(a).

c. *Default*. ECI may include capital gains derived from the ownership of interests in United States real property (or entities owning interests in United States real property), under the rules of the Foreign Investment in Real Property Tax Act ("FIRPTA"). I.R.C. §897(a)(1).

ii. FDAP. FDAP is income from passive sources in the United States, such as interest, dividends, rents, and royalties. I.R.C. §871(a)(1). **FDAP is taxed at a flat 30% rate on the gross amount, without any deductions.** *Id.* Some interest is excluded from taxation altogether. This includes interest that is imputed on short term below market debts, interest on certain corporate debts (called "portfolio interest"), and interest on bank deposits that are not connected with a trade or business in the United States. I.R.C. §871(g)–(i). The tax rate for FDAP may be reduced under the Canadian Treaty. *See* Canadian Treaty, Art. X (limiting dividend tax to 5% (if a corporate payee owns at least 10% of the voting stock of the company paying the dividend) or 15%), Art. XII (limiting the tax on royalties to 10%).

iii. Withholdings. The payor of FDAP is required to withhold and pay the tax to the IRS. I.R.C. §§1441(a), 1461(a). Tax on ECI may also be subject to mandatory withholding at its source. For example, an NRA partner's share of a United States partnership's ECI is typically subject to withholding by the partnership, meaning the partnership must collect and pay the tax to the United States. I.R.C. §1446(a). Any gain on the disposition of real property that is subject to FIRPTA is generally subjects the buyer to withholding tax (see discussion below). I.R.C. §1445(a).

iv. FIRPTA. FIRPTA both treats the gain on the sale of an interest in United States real property as ECI and requires the payor (the buyer in a sale of real property) to withhold and pay a 15% tax (10% on transfers before 2/16/2016) to the IRS on the amount realized to the Canadian NRA transferor on the transaction. *See* I.R.C. §§897(a), 1445(a); *see also* §1445(e); Treas. Reg. §1.1445-1(a) (listing other special percentage withholding rates).

a. *Sales of Personal Residences*. The sale of a personal residence in the United States may be subject to gain exclusion or withholding exclusion under I.R.C. §121 or special FIRPTA rules.

b. *Section 121*. The familiar rules of I.R.C. §121 allow a taxpayer, including an NRA, to exclude up to $250,000 ($500,000 for a married couple filing jointly) of gain from the sale of a principal residence not acquired in a like-kind

exchange that was used as a principal residence for two of the prior five years. I.R.C. §121(a), (b), (d)(10). A "principal residence" for these purposes is the property the taxpayer uses as a residence the majority of the time and is deemed a principal residence based on all of the facts and circumstances, including the location of the taxpayer's employment, address used on official forms and correspondence, location of banks and religious or recreational clubs. *See* Treas. Reg. §1.121-1(b)(2). If the taxpayer used the property as a principal residence that previously was used as a vacation home or rental property, only a portion of the gain is excludible under I.R.C. §121. I.R.C. §121(b)(5). A transaction that is entirely excluded from gross income under I.R.C. §121 is also excluded from the FIRPTA withholding requirements. Treas. Reg. §1.1445-2(d)(2). The transferor must provide the transferee with notice of the exemption and the transferee must apply for a withholding certificate. *See* Treas. Reg. §1.1445-2(d)(2)(i); Rev. Proc. 2000-35, §4.05.

c. *FIRPTA Exclusion*. An NRA's sale of a residence to a transferee who intends to use the residence as the transferee's residence for at least 50% of the days in the first two 12-month periods after the sale is not subject to FIRPTA withholding if the amount realized is $300,000 or less. I.R.C. §1445(b)(5); Treas. Reg. §1.1445-2(d)(1).

d. *Special FIRPTA Withholding Rate*. If an NRA sells a residence to a transferee who acquired the property to use as a residence, and the amount realized was between $300,000 and $1,000,000, then the withholding rate is 10%, instead of 15%. Treas. Reg. §1.1445-1(b)(2). Certain entity distributions may also trigger a 35% withholding rate. *See* I.R.C. §897(e).

B. American Exit Tax. The United States imposes its own exit tax ("American Exit Tax") upon a citizen or long-term permanent resident becoming a "Covered Expatriate." I.R.C. §877A(a); *see also* Notice 2009-85, 2009-45 I.R.B. 598 (explaining the application of §877A(a)).

1. **Covered Expatriate.** A Covered Expatriate is (i) a citizen who gives up his or her United States citizenship or a long-term resident (a lawful permanent resident for eight of the last fifteen years) who loses his or her permanent resident status and (ii) who either has average annual net income (over the five most recent past years) of over $162,000 (inflation adjusted), or a net worth of $2,000,000 or more (not inflation adjusted), **or who fails to certify under penalty of perjury that he or she has met his**

or her tax obligations for the preceding five tax years (usually done on Form 8854), or failed to submit evidence of compliance as the IRS requested. I.R.C. §§877A(g)(1)(A), 2801(f); Rev. Proc. 2016-55.

2. **Tax.** A Covered Expatriate is treated as though he or she sold his or her assets on the expatriation date, recognizing gain or loss on the deemed sale. *See* I.R.C. §877A(a)(1), (2). The "expatriation date" is the date he or she loses United States citizenship or ceases to be a lawful permanent resident in the United States. I.R.C. §877A(g)(3). The Covered Expatriate is permitted to exclude up to $699,000 (inflation adjusted) from gain recognition. I.R.C. §877A(a)(3); Rev. Proc. 2016-55. The American Exit Tax does not apply to certain United States deferred compensation plans; IRAs (other than SEP IRAs and Simple IRAs), ABLE accounts, and certain education accounts; and interests in nongrantor trusts. I.R.C. §877A(c).

3. **Trust Interests.** Although nongrantor trust interests are not subject to the deemed disposition rules, distributions to a Covered Expatriate who was a beneficiary of a nongrantor trust immediately before the expatriation date are subject to 30% withholding tax in the United State on the taxable portion of the distribution. *See* I.R.C. §877A(f)(1).

   i. Taxable Portion. The "taxable portion" is the portion that would have been includible in the Covered Expatriate's gross income if he or she continued to be a United States citizen or resident. I.R.C. §877A(f)(2).

   ii. Beneficiary. A "beneficiary" is a person (a) who is entitled or permitted, under the terms of the trust instrument or applicable local law, to receive a direct or indirect distribution of trust income or corpus (including, for example, a distribution in discharge of an obligation of that person), (b) with the power to apply trust income or corpus for his or her own benefit, or (c) to whom the trust income or corpus could be paid if the trust or the current interests in the trust were then terminated. Notice 2009-85, 2009-45 I.R.B. 598, §7(A).

   iii. Convert Nongrantor Trust to Grantor Trust. If a trust that is a nongrantor trust immediately before the expatriation date becomes a grantor trust in which the Covered Expatriate is the owner after the expatriation date, the conversion is treated as a distribution subject to the 30% withholding. *Id.*

   iv. Withholding on Capital Gains. If the trust must pay capital gains (meaning it does not allocate capital gains to DNI) then a distribution of a capital asset is treated as a sale, but is not subject

to withholding. *See* I.R.C. §877A(f)(1)(B); Notice 2009-85, 2009-45 I.R.B. 598, §7(B).

v. Treaty Benefits. If the Covered Expatriate wants to claim benefits under the Canadian Treaty (e.g. lower withholding rates), then he or she must file Form 8854 and agree to be treated as selling his or her interest in the nongrantor trust. Notice 2009-85, 2009-45 I.R.B. 598, §7(D). The value of the interest in the nongrantor trust must be determined in a private letter ruling. *Id*.

C. International Transfer Tax. The United States has four transfer taxes that apply to residents, and in certain situations, to NRAs: Estate Tax, Gift Tax, GST Tax, and Expatriate Tax.

1. **Transfer Tax Resident.** Determining who is a resident for purposes of United States transfer taxes requires an entirely separate set of rules from those that apply for income tax purposes. **A "resident" for transfer tax purposes is a non-citizen individual whose "domicile" is in the United States**. Treas. Reg. §20.0-1(b)(1), 25.2501-1(b). Citizens are treated as residents. The income tax rules are irrelevant for determining the non-citizen individual's residency for transfer tax purposes (except to the extent income classification might be relevant to the facts and circumstances testing of domicile). An individual's domicile is initially established where he or she is born. *Est. of Khan v. Comm'r*, T.C. Memo 1998-22 (1998). The assumption is that domicile continues in the same location until it is shown to have changed. *Mitchell v. United States*, 88 U.S. 350, 353 (1874); *Est. of Nienhuys v. Comm'r*, 17 T.C. 1149, 1159 (1952). Domicile may change by choice if the individual physically moves to a new location with the intent to remain there indefinitely. Treas. Reg. §20.20-1(b)(1); *Mitchell*, 88 U.S. at 353; *Nienhuys*, 17 T.C. at 1159. Therefore, if a non-citizen individual is born outside of the United States, he or she can change domicile to the United States if two things occur at the same time: (1) he or she lives in the United States, and (2) he or she intends to remain in the United States with no intent to ever permanently move elsewhere. *Id.* Thus, unlike the income tax residency test, which is purely objective, the transfer tax domicile test is partly objective and partly subjective.

i. Determining Domicile. Whether an individual intends to remain in the United States is determined by looking at certain factors, including the location of: year-around residency, voter registration, making tax filings, business and property interests, driver's license, car registration, marital status, employment, family, civic engagement, and social memberships. *See Carlson v. Reed*, 249 F.3d 876, 880 (9th Cir. 2001); *Nienhuys*, 17 T.C. at 1149; *Est. of Blair v. United States*, 54 Fed. Cl. 590, 596 (2002) (quoting *Vlandis v. Kline*, 412 U.S. 441, 454 (1973)); *Khan*, T.C.

Memo 1998-22. In addition, it may be telling if the individual applies for permanent immigrant status or citizenship in the United States. *See Khan*, T.C. Memo 1998-22.

ii. Non-Immigrant Visas. If an individual acquires a non-immigrant visa and the visa requires the immigrant to swear he or she does not intend to reside in the United States permanently, then there is some support for the conclusion that the visa requirements prevent the individual from having the intent to change domicile to the United States. *See e.g. Carlson*, 249 F.3d at 880 (stating that because a TN/TD non-immigrant visa precluded the immigrant from intending to establish a permanent residence in the United States, California State University could deny the holder in-state tuition); *see also Toll v. Moreno*, 458 U.S. 1, 17 (1982) (concluding that, because a G-4 visa does not prohibit establishing a permanent residence, the University of Maryland could not preclude a holder from establishing domicile and qualifying for in-state tuition). That issue is not firmly concluded for transfer tax purposes, however. *See e.g. Carlson*, 249 F.3d at 880 (stating that federal law can preclude the subjective intent needed to change domicile); *contra Blair*, 54 Fed. Cl. at 599 (concluding that for Estate Tax purposes a decedent may establish domicile in violation of a visa); *and* Rev. Rul. 80-209, 1980-2 C.B. 248 (concluding that an individual not lawfully present in the United States can be domiciled in the United States). Therefore a non-immigrant visa holder who does not want to become a resident for transfer tax purposes may be wise to clearly establish he or she does not intend to remain in the United States permanently under the factors listed above and by complying with the restrictions of his or her non-immigrant visa.

iii. Treaty Tie-Breaker. The United States has entered into 19 treaties that deal with double taxation for transfer tax purposes, including the Canadian Treaty. These conventions contain Treaty-Tie Breaker provisions similar to the provisions discussed above with regard to income tax residency. The Treaty Tie-Breaker provisions indicate how to determine a person's residency if the person is a dual resident, meaning a resident for tax purposes under the laws of both treaty countries. In order to claim residency of the other country under the treaty **the taxpayer must file a timely return (e.g. Form 709 or 706) and attached a Form 8833 claiming the treaty benefits**. *See* I.R.C. §6114(a); Treas. Reg. §301.7701(b)-7(b), (c); Instructions to Form 8833.

2. **Estate Tax.**

i. Tax on Residents and Citizens. At death, all residents are subject to Estate Tax on their worldwide estates. I.R.C. §2001(a). Each resident is allowed to exclude $5,490,000 (indexed for inflation) for his or her worldwide estate from Estate Tax ("Exclusion Amount"). I.R.C. §2010(a); Rev. Proc. 2016-55. The "worldwide estate" includes all property the resident owns in the world, including foreign accounts, foreign investment funds, interests in foreign corporations or partnerships, foreign real estate, certain interests in trusts, and any other property located within or without the United States. I.R.C. §2031(a). In calculating the Estate Tax, the resident also adds to his or her worldwide estate the value of all gifts he or she made during life that are subject to Gift Tax (called his or her "adjusted taxable gifts"). I.R.C. §2001(b).

a. *Worldwide Estate*. A decedent's gross estate includes any interest in property (wherever located) that the decedent owned at death. I.R.C. §2033; Treas. Reg. §20.2033-1(a).

b. *String Provisions—Property Deemed Owned At Death*. In addition to property the decedent owned personally, the decedent is deemed to own certain property that the decedent transferred during life and over which the decedent retained certain rights or powers that the decedent did not release more than 3 years before the decedent's death (called the "String Provisions"). I.R.C. §2035(a). The String Provisions state that if a decedent held certain rights or powers over property or released those powers within 3 years of death, the value of the property over which the powers could have been exercised is included in the decedent's gross estate. There are four main Code sections (§§2036, 2037, 2038, and 2042) that are included in the String Provisions. In addition, Gift Tax the decedent or his or her estate paid on gifts made by the decedent or his or her spouse within 3 years of the decedent's death are included in the decedent's gross estate under the String Provisions. §2035(b).

c. *Deductions*. Each resident is also allowed certain deductions against the value of his or her worldwide estate. These deductions include deductions for administrative expenses of the estate (if not deducted for income tax purposes), I.R.C. §2053, deductions for gifts or bequests to a United States citizen spouse ("Marital Deduction"), I.R.C. §2056, and deductions for gifts or bequests to charities ("Charitable Deduction"). I.R.C. §2055. The resident may be allowed to use credits against Estate Tax, including credits for foreign estate, inheritance, legacy, or

succession taxes on the estate, as well as any credits allowed under a transfer tax treaty of the United States. I.R.C. §§2010–15; *see e.g.* Canadian Treaty, Art. XXIX B (allowing a credit against Estate Tax).

d. *General Limitations on Marital Deduction*. The Marital Deduction **only applies, however, if the spouse is a citizen of the United States**, unless the bequest is left in a particular type of trust (called a "qualified domestic trust" or "QDOT") or unless the spouse becomes a United States citizen within nine months after the resident's death. I.R.C. §2056(d). Article XXIX B(3) of the Canadian Treaty also permits a credit for bequests to a Canadian spouse, while other treaties between the United States and a foreign country may also provide that a bequest to a non-citizen spouse qualifies for the Marital Deduction (or a credit).

(a) Generally, a trust before or at the decedent's death cannot qualify as a QDOT unless the trust is a type of trust that would qualify for the Marital Deduction had the surviving spouse been a United States citizen, such as a qualified terminable interest property trust ("QTIP Trust"). I.R.C. §2056(b).

(b) To qualify as a QDOT (i) the trustee must be required to pay to the IRS the Estate Tax on any principal distributions during the surviving spouse's lifetime or on the value of the trust on the surviving spouse's date of death, as if such amounts were included in the first deceased spouse's estate and (ii) the first deceased spouse's executor must make a timely QDOT election. *See* I.R.C. §2056A(a), (b); Treas. Reg. §20.2056A-2.

e. *General Limitation of Charitable Deduction*. The Charitable Deduction applies to gifts or bequests that are made outright to charities, if the charity qualifies for a deduction. I.R.C. §2055(a). For a resident's Estate Tax purposes it does not matter if the charity is a United States charity or a charity in a foreign country, with a few exceptions. I.R.C. §2055(a), (e)(1). A gift or bequest of a partial interest in property may not qualify for the Charitable Deduction unless it is in the form of certain types of trusts (such as a charitable remainder trust ("CRT")) or property interests. I.R.C. §2055(e)(2). A CRT, however, must have a United States charity as its

remainder beneficiary. *See* I.R.C. §§170(c)(2)(A), 664(d)(1)(C), 2055(e)(2).

f. *Portability*. The surviving spouse may elect to receive his or her deceased spouse's unused exemption amount ("DSUE Amount"). I.R.C. §2010(c)(2)(B); Treas. Reg. §20.2010-1(d)(4). The DSUE Amount is equal to the deceased spouse's unused Exclusion Amount. The surviving spouse only receives the DSUE Amount if the deceased spouse's estate files a timely federal Estate Tax return (Form 706) and elects on the return to leave the DSUE Amount to the surviving spouse (colloquially called a "Portability Election"). Treas. Reg. §20.2010-2(a)(1). Even if the deceased spouse's estate is not otherwise required to file the Form 706, one is deemed required to be filed for purposes of making a Portability Election. *Id*. The Form 706 is due nine months after the deceased spouse's death, with a possible six month extension of time to file. I.R.C. §§6075(a), 6081(a); Treas. Reg. §§20.6075-1, 20.6081-1(b).

(a) An NRA surviving spouse may not take into account the DSUE Amount, except to the extent allowed under a treaty. I.R.C. §2102(b)(3)(A); Treas. Reg. §20.2010-3(e). Portability also does not apply, and is therefore unavailable, to the estate of an NRA deceased spouse. Treas. Reg. §20.2010-2(a)(5).

(b) If property is left to a non-citizen surviving spouse in a QDOT, then the DSUE Amount is reduced by the value of the QDOT property remaining at the time the QDOT is terminated by a final distribution or the value of the QDOT property on the death of the surviving spouse "on which estate tax is imposed under section 2056A." Treas. Reg. §§20.2010-2(c)(4); 20.2010-2(c)(5), ex. 3. The adjustments do not apply, however, if the surviving spouse becomes a United States citizen in some circumstances. Treas. Reg. §20.2010-2(c)(4)(ii).

g. *Tax Rate*. The maximum rate of the Estate Tax on residents is 40%. I.R.C. §2001(c).

ii. Tax on NRAs. Unlike residents, NRAs are only subject to Estate Tax on their property located within the United States. I.R.C. §§2101(a), 2106(a). Property is generally located within the

United States if it is physically in the United States, though there are a few special exceptions. I.R.C. §2104. Stock in United States corporations is always treated as located within the United States. I.R.C. §2104(a). A debt owed by a United States person, or the United States, a State, or the District of Columbia (or a subdivision, agency, or instrumentality of either) is located within the United States. I.R.C. §2104(c). Life insurance on the NRA's life is not located within the United States. I.R.C. §2105(a). Non-business deposits in bank accounts, deposits in the foreign branch of a United States bank, and certain other debt obligations (called "portfolio interest" and "original issue discount" obligations) are also not located within the United States. I.R.C. §2105(b). Artwork that is in the United States on exhibition, loaned for exhibition, or in transit to or from exhibition is not located within the United States. I.R.C. §2105(c).

a. *Stock in Foreign Corporations*. The regulations are clear that stock in a foreign corporation is not located within the United States, regardless of the situs of the foreign corporation's assets. Treas. Reg. §20.2105-1(f). This makes foreign corporations useful Estate Tax planning vehicles for NRAs.

b. *Interests in Foreign Partnerships*. In contrast, the law is somewhat unclear on the situs of a partnership interest. In Rev. Rul. 55-701, 1955-2 C.B. 836, the IRS concluded that the situs of a partnership interest was the location of its business—suggesting perhaps that an interest in a foreign partnership owning assets in the United States could be treated as located within the United States. In *Sanchez v. Bower*, 13 AFTR 1074 (2nd Cir. 1934), the Second Circuit concluded that an NRA decedent was treated as owning a share of foreign partnership assets where the partnership terminated upon his death. Beyond these circumstances, the situs of a foreign partnership interest is unclear—and even the guidance is inconclusive. *See also* Zeydel and Chung, Estate Planning for Noncitizens and Nonresident Aliens: What Were Those Rules Again?, J. Tax'n (Jan. 2007).

c. *Special Rules of §2104(b)*. If an NRA transfers property in trust and retains any power described in the String Provisions (or releases the powers within three years of death) and the trust property was located within the United States (1) when the property was transferred to the trust **or** (2) on the date of the NRA's death, then the trust property would be included in the NRA's estate. I.R.C. §2104(b).

When the trust is funded with property situated within the United States then the provisions of §2104(b) override all contrary provisions related to estate inclusion to cause the trust property at the time of the NRA's death to be included in the NRAs estate (the trust is thus "tainted"). *See* TAM9507044. If the trust is not funded with property situated within the United States but holds United States property at the time of the NRA's death, the location of property is determined under ordinary NRA Estate Tax situs rules. *See Estate of Swan v. Comm'r*, 247 F.2d 144, 148 (2nd Cir. 1957); Rev. Rul. 82-193; PLR200243031. Taxpayers should be cautious with this principal. Section 2104(b) states that it applies to transfer "**in trust or otherwise**." The String Provisions have similar language. The Section 2036 regulations give the example of a transfer of the taxpayer's residence with a retained right to use the property for a term of years. Treas. Reg. §20.2036-1(c)(1)(ii) ex. 2. **Thus the planner must be conscientious that Section 2104(b) could apply to non-trust transfers as well, such as transfers of property or exchanges with entities.** *See id.*; *see also Est. of Bongard*, 124 T.C. 95 (2005) (reciting that in the context of family limited partnerships, Section 2036 may apply if there is no legitimate nontax purposes for the entity); *Kimbell v. United States*, 371 F.3d 257, 266 (5th Cir. 2004) (stating the Section 2036 would be implicated if the interests credited to each of the partners were not proportionate to the fair market value of the assets each partner contributed to the partnership, the assets contributed by each partner were not properly credited to the respective capital accounts of the partners, and if, on termination or dissolution of the partnership, the partners were not entitled to distributions from the partnership in amounts equal to their respective capital accounts). **These rules can have harsh results.** For example, improper planning when the trust is created can cause the trust property to be tainted under I.R.C. §2104(b) such that the trust property would always be subject to Estate Tax on the NRA's death, regardless of where the trust assets are located and even if the trust assets would not be included in the NRA's gross estate if the NRA owned the trust property outright and free of trust at the time of his or her death. Likewise, investment of trust property in United States property would cause the property to be included in the NRA's estate if the trust owns the United States property at the time of the NRA's death, even if he or she was never a

resident of the United States or never directly owned United States property. The application of I.R.C. §2104(b) is illustrated in **Illustration A**.

d. *Beneficial Interests in Trusts*. An NRA's beneficial interest in a trust may also be includible in his or her estate, notwithstanding any I.R.C. §2104(b) if the trust owns United States situs assets. This, to the extent of the trust's United States situs assets (proportionate to the beneficiary's interest) the NRA will include the trust property in the NRA's gross estate. *See* Rev. Rul. 82-193, 1982-2 C.B. 219; Rev. Rul. 55-163, 1955-1 C.B. 674.

e. *Jointly-Owned Property*. Although the general rule is the jointly held property is treated as owned one half by each spouse, this rule does not apply if the surviving spouse is a non-citizen of the United States. I.R.C. §§2040(b), 2056(d)(1)(B). Instead, each spouse is deemed to own that portion of the joint property attributable to the consideration each spouse gave for his or her joint interest. I.R.C. §2040(a).

f. *Deductions*. Each NRA is entitled to the deductions against Estate Tax (including the Marital Deduction and the Charitable Deduction) and credits listed above, subject to similar restrictions. I.R.C. §2106(a). Deductions for administrative expenses and casualty losses of the estate are permitted on pro rata basis based on the ratio of the estate situated in the United States versus the total worldwide estate. I.R.C. §2106(a)(1). The Charitable Deduction, however, is only permitted for an NRA if the property is left to a United States charity. I.R.C. §2106(a)(2)(A). The Charitable Deduction is also limited so that it cannot exceed the value of the property transferred to the charity that was required to be included in the NRA's gross estate. I.R.C. §2106(a)(2)(D). **A deduction for administrative expenses, casualty losses, and the Charitable Deduction are only available if the NRA's executor discloses the NRA's worldwide estate on the estate tax return.** I.R.C. §2106(b).

g. *Tax Rate and Exemption*. **Each NRA has a special Exclusion Amount of only $60,000 (which is not indexed for inflation).** I.R.C. §2102(b)(1). Thus, the taxable estate located within the United States in excess of $60,000 and any deductions is subject to tax at a maximum rate of 40%. I.R.C. §2101(b).

3. **Gift Tax.**

i. Tax on Residents. Residents must pay Gift Tax on any worldwide gifts. I.R.C. §2501(a)(1). Each resident, however, is allowed to exclude certain gifts from the Gift Tax:

- Up to $14,000 (indexed for inflation) of gifts of present interests or income in property to each recipient each year (called the "Annual Exclusion Amount"), I.R.C. §2503(b);
- Direct payment of medical or educational expenses, I.R.C. §2503(e);
- Waivers of certain rights in retirement benefits and loans of artwork to certain charities, I.R.C. §2503(f), (g); and
- Gifts in special trusts for minors, up to the Annual Exclusion Amount (all of the exclusions other than the Annual Exclusion Amount are referred to as the "Other Exclusions"). I.R.C. §2503(c).

a. *Exclusion Amount*. In addition, for worldwide gifts each year in excess of the Annual Exclusion Amount and the Other Exclusions, the resident is entitled to exclude up to $5,490,000 (indexed for inflation) in gifts during the resident's lifetime (called the "Lifetime Exclusion Amount"). I.R.C. §2505(a); Rev. Proc. 2016-55.

b. *Portability*. A surviving spouse may also use any DSUE Amount during his or her lifetime against his or her taxable gifts. Treas. Reg. §25.2505-2(a)(1).

c. *Deductions*. Similar to the Estate Tax, gifts are also eligible for a Marital Deduction and Charitable Deduction. I.R.C. §§2522, 2523.

d. *Marital Deduction*. **Gifts to a non-citizen spouse are not eligible for the Marital Deduction**, even if made to a trust, but are eligible for a special Annual Exclusion Amount of $149,000 (indexed for inflation). I.R.C. §2523(i); Rev. Proc. 2016-55.

e. *Charitable Deduction*. The Charitable Deduction is subject to similar limitations as discussed above in relation to the Estate Tax. I.R.C. §2522(a).

ii. Tax on NRAs. An NRA is only subject to Gift Tax on gifts of **tangible property** that is located within the United States. I.R.C.

§2501(a)(2). Except for certain expatriates, an NRA's transfers of intangible property are not subject to Gift Tax. I.R.C. §2501(a)(2). Certain expatriates are subject to Gift Tax on gifts of intangible personal property that is located within the United States. I.R.C. §2501(a)(5). Thus, a gift of real estate or tangible personal property that is physically located within the United States is subject to Gift Tax. Treas. Reg. §25.2511-3(a)(1). The NRA is allowed an Annual Exclusion Amount (but **no Lifetime Exclusion Amount**), I.R.C. §§2503(b), 2505(a), and Other Exclusions, I.R.C. §2503(c)–(g), and is eligible for the Marital Deduction and the Charitable Deduction on similar conditions as a resident except the Charitable Deduction is only permitted for gifts to United States charities. I.R.C. §§2522(b), 2523.

iii. Tax Rate. The maximum rate of the Gift Tax on residents or NRAs is 40%. I.R.C. §2502(a).

4. **GST Tax.** The GST Tax is a 40% tax on any "transferor's" transfer subject to Estate Tax or Gift Tax that is made to a person two or more generations below the generation of the transferor (called a "skip person"). I.R.C. §§2601, 2602, 2611, 2613, 2652(a).

i. Exemption. Unlike the Estate Tax and Gift Tax, however, where an NRA has a limited Exclusion Amount or no Lifetime Exclusion Amount, each resident and NRA is entitled to an exemption against GST Tax equal to $5,490,000 (indexed for inflation). I.R.C. §2631(c); Treas. Reg. §§26.2632-1, 26.2663-2(a); Rev. Proc. 2016-55.

ii. Identifying the Transferor. A transferor is the decedent (with respect to property transferred that is subject to Estate Tax) or the donor (with respect to property transferred that is subject to Gift Tax). I.R.C. §2652(a). As a result of this definition, any transfer not subject to Estate Tax or Gift Tax is not subject to GST Tax, including an NRA's transfer that is not subject to Estate Tax or Gift Tax. A transfer is deemed subject to GST Tax if it is includible in the decedent's gross estate or is subject to Gift Tax under §2501(a) (without regard to exemptions, exclusions, deductions, and credits). Treas. Reg. §26.2652-1(a)(2). Thus, even if a gift qualifies for the Annual Exclusion, the donor is in most circumstances still deemed the transferor for GST Tax purposes. *See* I.R.C. §2611(b); Treas. Reg. §26.2652-1(a)(2).

5. **Expatriate Tax.** United States citizens, residents (for transfer tax purposes), domestic trusts, and foreign trusts electing to be treated as domestic trusts ("Electing Foreign Trusts") receiving gifts or bequests from a Covered Expatriate (*see* Section II(B)(1) above) are subject to a

40% tax on the value of the gift or bequest (called a "Covered Gift" or "Covered Bequest") over the Annual Exclusion Amount. I.R.C. §2801(a). This tax does not apply to gifts or bequests to NRAs. *Id*. This means that an NRA who becomes a resident is required to determine whether a gift from a foreign source is from a Covered Expatriate. *See* Prop. Treas. Reg. §28.2801-7(a). Because the tax liability for the Expatriate Tax falls on the donee, it functions as a federal inheritance tax, instead of strictly as a transfer tax.

i. Foreign Trusts. The Expatriate Tax applies to distributions from foreign trusts that are not Electing Foreign Trusts and that may have received contributions from a Covered Expatriate. *See* Prop. Treas. Reg. §28.2801-5(c)(3). The foreign trust itself is not subject to the 40% tax, instead the receipt of the Covered Gift or Covered Bequest effectively taints the trust, so that each United States citizen or resident who receives a distribution from the trust is subject to the 40% tax to the extent that the distribution is attributable to a Covered Gift or Covered Bequest. Prop. Treas. Reg. §28.2801-4(a)(3)(i).

ii. Identifying Covered Gifts or Covered Bequests. The burden is on the United States citizen or resident to determine whether a gift or bequest is from a Covered Gift or Covered Bequest. If the recipient cannot determine whether the gift or bequest is from a Covered Expatriate, then the IRS's position is that it is from a Covered Expatriate. *See* Prop. Treas. Reg. §28.2801-5(c)(3); *see also* Prop. Treas. Reg. §28.2801-7(a) (assuming that if an expatriate does not share tax information that he or she is a Covered Expatriate). Each resident, domestic trust, or foreign trust might consider refusing gifts or bequests from Covered Expatriates to avoid issues caused by the tax on Covered Gifts and Covered Bequests.

D. Foreign Trusts. This Section discusses how a trust can be deemed a foreign trust, then discusses how each is taxed in the United States, and finally it discusses special rules that relate to immigration.

1. **Defining Foreign Trusts.** Under the United States tax laws, all trusts are assumed to be "foreign trusts" unless two things are true: (1) a court within the United States has primary supervision over the trust administration (the "Court Test"), **and** (2) one or more United States persons has authority to control all substantial decisions of the trust (the "Control Test"). I.R.C. §7701(a)(30)(E); Treas. Reg. §301.7701-7(a)(1). The term "United States persons" for purposes of the Control Test are persons who are citizens or residents for income tax purposes. Treas. Reg. §301.7701-7(d)(1)(i).

i. Substantial Decisions. The term "substantial decisions" means any decisions authorized under the trust agreement that are not ministerial. Treas. Reg. §301.7701-7(d)(1)(ii).

ii. Non-Ministerial Decisions. Decisions that are not ministerial include decisions **other than** bookkeeping, collecting rent, and executing investment decisions, and would include decisions about distributions (when to make them and in what amounts), selection of beneficiaries, allocating receipts to income or principal, terminating the trust, resolving claims against the trust, determining whether to sue on behalf of the trust or to defend suits against the trust, the removal or replacement of a trustee, the appointment of a successor trustee (unless that would change the residency of the trust from foreign to domestic or vice versa), or investment decisions or hiring an investment advisor (unless a United States Person can terminate the investment advisor). *Id.*

iii. Power to Control. The power to make a decision without another person holding the power to veto the decision is considered the power to control under the Control Test. Treas. Reg. §301.7701-7(d)(1)(iii). To determine whether a United States Person has the power to control substantial decisions, one must consider all of the powers of all persons over the trust—not just the power of the trustees or other fiduciaries. *See id.* Control also exists if a person is alone able to make a particular decision, even if other persons can only veto that decision. *See* Treas. Reg. §301.7701-7(d)(1)(v), ex. 3. If a person has the ability to make a particular decision but other persons can accept or veto those decisions and make any decisions the first person does not make, then the first person does not have control. *See* Treas. Reg. §301.7701-7(d)(1)(v), ex. 4. Where a resident co-trustee and an NRA co-trustee had to make decisions by majority consent, but the trust agreement granted the trustee that was a resident of the United States with power to make decisions without the input of the NRA co-trustee, the IRS privately determined the trust was not a foreign trust. CCA201509035. Where an NRA could revoke the trust, the IRA privately ruled the trust was a foreign trust because the NRA effectively could control all substantial decisions. PLR200243031.

iv. Inadvertent Powers. If there is an inadvertent event that causes a foreign trust to become a domestic trust, or vice versa, the trust is allowed twelve months from the event causing the change to take actions to prevent the change of residency of the trust. Treas. Reg. §301.7701-7(d)(2)(i).

a. *Inadvertent Events*. An "inadvertent event" means the death, incapacity, resignation, change in residency, or other

change with respect to the person who holds a substantial decision-making power over the trust that was not intended to change the residency of the trust but would change the trust's residency. *Id.*

b. *Failure to Rectify*. If the inadvertent event is not rectified by the end of the twelve-month period, then the trust's residency is treated as changing on the date of the inadvertent event. *Id.* If situations outside of the trustee's control prevent the trustee from rectifying the change within the twelve-month period, and the IRS determines there is reasonable cause after the trustee asks for an extension, then the IRS may grant an extension of time. Treas. Reg. §301.7701-7(d)(2)(ii).

2. **Domestic Trusts.** If a trust is not a foreign trust then it is a "domestic trust." *See* Treas. Reg. §301.7701-7(a)(2).

3. **Trust Taxation.**

i. Grantor Trusts. Grantor trusts, whether they are foreign trusts or domestic trusts, are not subject to taxation (to the extent a person is treated as the owner of the trust property). I.R.C. §671(a). Instead, the person who is treated as owning the trust property is taxed on the income generated by the grantor trust. Thus, for example, if a resident (for income tax purposes) is treated as owning the assets of a foreign trust, the resident would be subject to the tax and foreign information return requirements relating to the foreign trust's foreign assets. If a domestic grantor trust has owners who are NRAs, then the trust itself becomes the withholding agent for purposes of withholding tax on FDAP or certain ECI. *See* Treas. Reg. §1.1441-5(b)(2)(iv). In that case the withholding must be on that portion of the trust income consisting of FDAP or ECI subject to withholding that the NRA is treated as owning. *Id.*

ii. Nongrantor Trusts. Nongrantor trusts are taxed differently, depending on whether they are foreign trusts or domestic trusts and depending on whether they have United States beneficiaries (including residents who are beneficiaries).

a. *Foreign Nongrantor Trusts*. A foreign nongrantor trust is taxed in the United States in the same manner as an NRA, as discussed above. I.R.C. §641(b). Thus, a foreign nongrantor trust would be taxed in the United States only on its ECI and FDAP income, and it would be subject to the FIRPTA rules in relation to any interests it has in United States real property.

(a) If the foreign nongrantor trust distributes its ECI income to its beneficiaries, however, the trust beneficiaries would be taxed on that income and not the trust. *See* I.R.C. §§651, 661, 873(a); Rev. Rul. 85-60, 1985-1 C.B. 187.

(b) If the foreign nongrantor trust has FDAP income then it cannot shift the tax liability to its beneficiaries. *See* I.R.C. §871(a).

(c) If a foreign nongrantor trust is required to distribute its income to United States beneficiaries annually, then the United States beneficiaries would pay tax on their share of the trust income each year. I.R.C. §§662, 665(a).

(d) If the foreign nongrantor trust has Untied States beneficiaries and has income it is not required to distribute to the United States beneficiaries annually, then special anti-deferral tax rules apply. While the trust is permitted to accumulate the income, if the trust distributes that accumulated income to the United States beneficiaries in a later year, the United States beneficiaries are taxed on the accumulated income at ordinary income rates (even if the income derived from capital gains or lower tax character income) and are subject to an interest charge dating back to when the income was accumulated (the so called "Throwback Rule"). I.R.C. §§643(b), 652, 665(b), 666(a), 667.

(e) In addition, if the United States beneficiary or grantor (meaning a person who made a gift to the trust) is permitted to use any trust property directly or indirectly without paying adequate rent or the trust makes a loan (that is not a "qualified obligation") directly or indirectly to the United States beneficiary or grantor (or his or her relative) then the value of the use of the property or the loan amount are treated as a distribution to the United States beneficiary or grantor (which could trigger the Throwback Rule). I.R.C. §643(i); *see also* Notice 97-34 (defining qualified obligations as, among other things, any obligation that is in writing, matures in no more than 5 years, payments on the loan are made only in United States dollars, and the yield to maturity is at least 100% and not

over 130% of the applicable adjusted federal rate). These rules also apply if the trust makes a distribution to a person who is not a grantor of the trust and then that person pays the amount to the United States beneficiary of the trust as part of a plan with the principal purpose of tax avoidance. I.R.C. §643(h); Treas. Reg. §1.643(h)-1(a)(1); *see also* Treas. Reg. §1.643(h)-1(a)(2) (describing rules related to determining if a transfer is part of a plan to avoid tax).

b. *Domestic Nongrantor Trusts*. Domestic nongrantor trusts are taxed in the United States in the same manner as a resident, with certain special rules. I.R.C. §641(b). Domestic nongrantor trusts and their beneficiaries are thus subject to taxation under the ordinary distributable net income provisions on their worldwide income. *See* I.R.C. §§651–52, 661–62.

(a) If the domestic nongrantor trust has beneficiaries who are NRAs, then the trust itself becomes the withholding agent for purposes of withholdings required on FDAP and some ECI. *See* Treas. Reg. §§1.1441-5(b)(2)(ii), 1.1441-5T(b)(2)(iii). In the case of a simple trust the withholding must be on that portion of the trust distributable net income consisting of FDAP or ECI subject to withholding that is includible in the NRA beneficiary's gross income. Treas. Reg. §1.1441-5(b)(2)(ii). In the case of a complex trust the withholding must be on that portion of the trust distributable net income consisting of FDAP or ECI subject to withholding that is includible in the NRA beneficiary's gross income and is, or is required to be, distributed to the beneficiary. Treas. Reg. §1.1441-5T(b)(2)(iii).

(b) This can be a positive result because distributable net income is calculated based on the trust's taxable income under I.R.C. §63 (with certain adjustments in Treas. Reg. §§1.643(a)-1 through 1.643(a)-7), meaning the FDAP or ECI included in the distributable net income is included on a partial net basis. If the NRA beneficiary owned the asset producing that income direction, the withholding tax would be on a gross basis absent an 897(d) Election. For example, if the domestic nongrantor trust has rental income, its taxable income would be

calculated by taking into account any deductions against the rental income, those deductions are not added back when calculating distributable net income, and the withholding tax on the rental income (which is FDAP unless a 871(d) Election is made) is on the net rental income includible in distributable net income. *See e.g.* Treas. Reg. §§1.652(b)-1 and 1.662(b)-1 (stating that income in the hands of the beneficiary is of the same character as in the hands of the trust).

iii. Special Immigration Rules. Having a foreign or domestic grantor trust that is treated as owned by an NRA can be extremely tax advantageous to the trust's United States beneficiaries. This is because the NRA owner is not subject to United States taxes (except on United States source income) and any distribution from the trust to the United States beneficiary would be a gift from the NRA owner and would not be taxable to the beneficiary. In light of this, the United States tax laws have special rules that favor treating grantor trusts with foreign owners as nongrantor trusts or as being owned by a United States person.

a. *Grantor Trust Prevention Rules*. The special rules provide that a foreign or domestic grantor trust with United States beneficiaries would not be treated as owned by an NRA unless: (1) the NRA (or the NRA's spouse) can revoke the trust (for at least 183 days in the tax year) without anyone else's consent or with the consent of a person who is a related or subordinate party that is subservient to the NRA, (2) the trust only permits distributions to the NRA (or his or her spouse) during the NRA's lifetime, (3) the trust was created to compensate a party for services, or (4) the trust was created and funded on or before September 19, 1995. I.R.C. §672(f)(2)(A), (B); Treas. Reg. §1.672(f)-3. Additionally, if a resident transfers assets to an NRA (other than assets worth less than $14,000 or sales for full value), and the NRA then transfers the assets into a foreign trust, the resident (and not the NRA) would be treated as the owner of the trust assets. I.R.C. §672(f)(5).

b. *United States Transferor Created Foreign Trusts*. If a resident makes a transfer to a foreign trust with United States beneficiaries, then the resident would be treated as the owner of the trust assets (the trust would be a grantor trust), regardless of any other rules that would cause the trust to be nongrantor or treated as owned by any other person. I.R.C. §679(a)(1). This does not apply if the

transfer is for fair market value consideration or to a deferred compensation trust. *See id.*; I.R.C. §6048(a)(3)(B)(ii).

c. *Pre-Immigration Transfers to Trusts*. If an NRA transferred assets to a foreign trust within 5 years before becoming a resident (the "Immigrant"), and the trust has United States beneficiaries, then the Immigrant can be treated as the owner of the foreign trust's assets. I.R.C. §679(a)(4). An Immigrant is treated as having transferred assets to a foreign trust if he or she released a power over the foreign trust that changed the trust from a grantor trust to a nongrantor trust. Treas. Reg. §1.679-5(b)(1). As a result, any change from a grantor trust to a nongrantor trust within 5 years before becoming a resident would also cause the Immigrant to be treated as the trust owner. Treas. Reg. §1.679-5(c), ex. 2. Thus, the foreign trust would be taxed as a grantor trust, with the Immigrant taxable for all of the trust's income and subject to all foreign information return requirements relating to the trust's assets.

d. *Outbound Grantor Trust Transfers*. If a resident transfers property to a domestic trust and the domestic trust later becomes a foreign trust during the resident's lifetime, then the resident is treated as if he or she made a transfer to the foreign trust on the date the domestic trust became a foreign trust. I.R.C. §679(a)(5). If the trust, at the time it became a foreign trust, has United States beneficiaries, then the trust would be treated as a grantor trust with the resident transferor as the owner. I.R.C. §679(a). If the trust, at the time it became a foreign trust, does not have United States beneficiaries, then the trust transferor would be treated as having sold all of the trust property to the foreign trust. *See* I.R.C. §684(a).

e. *Outbound Nongrantor Trust Transfers*. The United States tax rules also do not favor transferring property from a resident to a foreign nongrantor trust. As a result, if a resident directly or indirectly transfers property to a foreign nongrantor trust, the resident is treated as though he or she sold all of the property at its fair market value, and must pay tax on the gain from that sale. I.R.C. §684(a); CCA200445025.

(a) The resident is not allowed to recognize any losses on this deemed sale. Treas. Reg. §1.684-1(a)(2).

(b) This deemed sale rule does not apply to transfers to foreign grantor trusts, certain transfers upon the death of the resident, transfers to charitable trusts, transfers by sale or exchange for full value (if the resident or his or her relatives are neither treated as owners of the trust assets nor trust beneficiaries), certain transfers by United States corporations, or certain trust distributions to other trusts or entities. Treas. Reg. §1.684-2(a)–(f).

(c) The deemed sale rule would apply if a resident was the owner of the assets of a foreign grantor trust and the trust became a foreign nongrantor trust (for example because the resident released powers over or interests in the trust or the trust could no longer have United States beneficiaries). *See* I.R.C. §684(a); Treas. Reg. §1.684-2(d), ex. 2.

f. *Immigration Issues*. Within these special rules the migration of an NRA or resident, or foreign or domestic trust, into and out of the United States can have significant consequences. For example, if an NRA becomes a resident, then any trusts created within 5 years of that change may become grantor trusts. If the individual then migrates out of the United States, and becomes an NRA again, the individual may be treated as having sold all of the trust property. If an NRA creates a domestic nongrantor trust and the trust later becomes a foreign nongrantor trust (either because it changes its law to a foreign jurisdiction or an NRA becomes trustee with the power to make administrative decisions), the trust would be treated as selling all of its assets on the date of the change. *See* Treas. Reg. §1.684-4(a).

g. *Death*. In addition, if a resident is treated as the owner of a foreign trust's assets, the foreign trust is not included in the resident's estate for Estate Tax purposes, and the resident dies, then the resident would be treated as having sold the assets in the trust on his or her date of death. Treas. Reg. §1.684-3(c). After the death of the resident who was treated as the owner of the foreign trust's assets, the foreign trust would become a foreign nongrantor trust and any United States beneficiaries would be subject to the Throwback Rules and foreign information return requirements related to indirect ownership of the trust's assets.

III. <u>IMPORTANT CANADIAN TREATY PROVISIONS</u>. Several important treaty provisions related to individuals have been mentioned above, but a few more also bear mentioning. Anytime a practitioner is dealing with a client who has ties with Canada, it is important for the practitioner to determine whether the Canadian Treaty applies. In order to claim the benefits of the Canadian Treaty for United States tax purposes, generally the IRS position is that the taxpayer must file a timely United States tax return (even if one was not otherwise required) and attach a Form 8833. *See* Treas. Reg. §§301.6114-1(a)(1)(ii), 301.6114-1(c), 301.7701(b)-7(b), (c).

A. <u>Hybrid Entities</u>. The Canadian Treaty permits owners of certain entities that are treated as fiscally transparent (e.g. pass-through entities) in one state but not the other to be treated as the recipients of income, profit, or gain directly, and therefore entitled to the treaty benefits, or where the law of the different countries treats the payment differently, as not receiving the payment at all. Canadian Treaty, Art. IV(6), (7). These rules can have drastic effects and are described in more detail below.

1. **Fiscally Transparent Entities.** A resident of Canada or the United States (the "<u>resident state</u>") **is treated as the recipient** of income, profit, or gain from the other state if he or she is considered under the law of the resident state to have derived the income, profit, or gain through an entity, and the entity is fiscally transparent under the resident state's laws (even though the entity may not be fiscally transparent in the state from which the payment originated). *Id.* In that case the recipient is treated as receiving the income, profit or gain directly for purposes of the Canadian Treaty. In the United States, fiscally transparent entities would include partnerships, LLC that have not elected to be taxed as corporations, grantor trust, and Qualified Subchapter S Subsidiaries. Fiscally transparent entities in Canada would include partnerships and "bare" trusts.

   i. For example, if a United States resident derived Canadian-source dividends through a French entity that is treated as fiscally-transparent in the United States but as a corporation in Canada, the United States resident is treated as receiving the dividend payment directly, and thus being entitled to the treaty benefits related to reduce dividends withholding taxes in Canada.

   ii. Likewise, if a Canadian resident derives United States-source dividends through a Canadian entity that is treated as a partnership in Canada but as a corporation in the United States (for example, because it permits its members limited liability protection), the Canadian resident is treated as receiving the dividend directly, and thus getting to use the treaty benefits related to reduced dividends withholding taxes in the United States.

2. **Non-Fiscally Transparent Entities.** An amount of income, profit or gain is considered **not to be paid** to or derived by a person who is a resident of

Canada or the United States (the "residence state") if (1) the other state (the "source state") views the person as deriving the amount through an entity that is not a resident of the residence state, and (2) by reason of the entity not being treated as fiscally transparent under the laws of the residence state, the treatment of the amount under the tax law of the residence state is not the same as its treatment would be if that amount had been derived directly by the person. Canadian Treaty, Art. IV(7)(a). Thus the person would not be entitled to any treaty benefits (because they did not receive the income).

i. For example, if a United States resident has an interest in a Canadian entity that is a partnership for Canadian purposes and a corporation for United States purposes and the Canadian entity received a dividend distribution from a Canadian company in which is owns stock, the United States resident is not treated as receiving a payment directly and cannot use the treaty benefits because the tax treatment under United States laws would not be the same if the dividend was paid to the Canadian entity versus the United States person directly.

3. **Miss-Matched Transparency.** An amount of income, profit or gain is **not considered to be paid** to or derived by a resident of Canada or the United States (the "residence state") if: (1) the other state (the "source state") views such person as receiving the amount from an entity resident in the source state; (2) the entity is viewed as fiscally transparent under the laws of the residence state; and (3) by reason of the entity being treated as fiscally transparent under the laws of the residence state, the treatment of the amount received by that person under the tax law of the residence state is not the same as its treatment would be if the entity were not treated as fiscally transparent under the laws of the residence state. Canadian Treaty, Art. IV(7)(b).

i. For example, a United States resident owns a Canadian company that for Canadian purposes is treated as a corporation and United States purposes as a disregarded entity, and the Canadian company pays a dividend to the United States resident, the United States resident would be treated as if he or she did not receive a payment directly for purposes of applying the treaty benefits.

B. **<u>Rent</u>.** Income derived by a resident of one state from real property located in the other state may be taxed in the other state. Canadian Treaty, Art. VI(1). This does **not** create an exclusive right in the other state to tax the income. Instead, each state can tax the income, but both Canada and the United States allow a non-resident to elect to tax income from real property on a net basis.

C. **<u>Dividends</u>.** Dividends of a company that is resident in one state paid to a resident of the other state may be taxed in the other state. Canadian Treaty, Art. X(1).

The dividend may also be taxed in the state where the company is resident but the tax rate on the dividend is 5% for a corporate taxpayer owning at least 10% of the voting control of the company, or 15% in other circumstances. *See* Canadian Treaty, Art. X(2).

D. **<u>Interest</u>.** Interest paid from a source in one state to a resident of the other state **may only** be taxed in the other state. Canadian Treaty, Art. XI(1). This provision has the effect of causing interest to have a **$0 withholding rate**, which can be hugely beneficial. "Interest" includes "income from debt-claims of every kind, whether or not secured by mortgage." Canadian Treaty, Art. XI(2). It does not include any income that is treated as a dividend. *Id.* It also does not apply if the recipient is carrying on a business in the other state through a permanent establishment in the other state and the interest is effectively connected with that permanent establishment. Canadian Treaty, Art. XI(3). If there is a special relationship between the payor and the payee such that the payor pays more interest than would have been paid but for that special relationship, the excess interest amount is taxable in the state from which it is paid. Canadian Treaty, Art. XI(5).

1. **United States Contingent Interest.** The rule in Article XI(1) does not apply to interest arising in the United States that is "contingent interest" that does not qualify as portfolio interest. Canadian Treaty, Art. XI(6)(a). "Contingent interest" for purposes of this provision is defined in I.R.C. §871(h)(4), a rather complex provision that is beyond the scope of this outline. If the interest is United States contingent interest, then the United States may tax it on a gross basis at a 15% rate. Canadian Treaty, Art. XI(6)(a).

2. **Canadian Contingent Interest.** The rule in Article XI(1) does not apply to interest arising in Canada that is determined "with reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person" that is payable to a United States resident. Canadian Treaty, Art. XI(6)(b). If the interest is Canadian contingent interest, then Canada may tax it on a gross basis at a 15% tax rate. *Id.*

3. **REMICs.** Interest that is excess inclusion with respect to a residual interest in a real estate mortgage investment conduit ("<u>REMIC</u>") can be taxed by the United States and Canada. Canadian Treaty, Art. XI(6)(c). The rules related to excess inclusion with respect to a residual interest in a REMIC are found in I.R.C. §§860E(e) and 860G(b) and are beyond the scope of this outline.

E. **<u>Royalties</u>.** Royalties that are paid from a source in one state to a resident of the other state **may only** be taxed in the other state. Canadian Treaty, Art. XII(1). The royalties may also be taxed in the state where they arise at a 10% tax rate,

unless they arise from literature; music; artistic work (other than film); computer software; industrial, commercial, or scientific experience (other than from a rental or franchise agreement); or broadcasting. Canadian Treaty, Art. XII(2), (3).

F. **Capital Gains.** Gains from the sale of real property by a resident of one state that was located in the other state may be taxed in the country where the real property was located. Canadian Treaty, Art. XIII(1). Gains from the sale of personal property forming part of the business property of a permanent establishment that a resident on one state has in the other state are tax in the other state. Canadian Treaty, Art. XIII(2).

1. **Special Rules Related to Real Property.**

i. Definition. Real property includes the following:

a. *United States Real Property.* In the case of real property situation in the United States, "real property" is real property (or an interest in real property) situated in the United States, but not an interest in a shares of capital stock of a company that is not resident in the United States. Canadian Treaty, Art. XIII(3)(a).

b. *Canadian Real Property.* In the case of real property situated in Canada, "real property" is real property (or an interest in real property) situated in Canada, a share of capital stock of a company that is resident in Canada the value of whose shares is derived principally from real property situated in Canada, or an interest in a partnership, trust, or estate the value of which is derived principally from real property situated in Canada. Canadian Treaty, Art. XIII(3)(b).

ii. New Basis for United States Immigrants from Canada. An individual (who is not a citizen of the United States) who was a resident of Canada and who becomes a resident of the United States is treated as having a basis in his or her personal residence in Canada equal to its fair market value at the time of expatriation from Canada for purposes of calculating his or her United States tax on the later sale of the residence. Canadian Treaty, Art. XIII(6). This provision effectively permits the former Canadian resident a new basis on his or her personal residence. Since the Canadian Exit Tax exempts Canadian real property, this provision locks in a single country of taxation (Canada) on the built-in-gain of the property as of the time the Canadian resident expatriates to the United States.

iii. Election to Treat Property as Sold in Both Countries. If a resident of the United States or Canada is treated as having sold property in one state, the resident may elect to be treated as also selling the same property in the other state. Canadian Treaty, Art. XIII(7). In this instance, the taxpayer would generate taxable income in both the United States and Canada, and would be permitted (generally) to a foreign tax credit against taxes paid in the other country. *See* Canadian Treaty, Art. XXIV. Effectively, the taxpayer is permitted a free basis adjustment in the country to which they are expatriating while only being subject to one level of taxation in the country from which they are expatriating. This means that all only future appreciation would be taxed in the new country or residency.

2. **Other Capital Property.** Gain from the sale of any other capital property (other than real property under XIII(1) and (3) or personal property under XII(2)) is taxable in the state where the seller is a resident. Canadian Treaty, Art. XIII(4). This rule does not prevent the other state from taxing the gain if (i) the individual was a resident of the other state for at least 120 months during any 20 consecutive years preceding alienating the property and at any time during the 10 years before alienating the property, and (ii) the individual owned the property when he or he ceased to be a resident of the other state and the property was not subject to an exit tax. Canadian Treaty, Art. XIII(5).

G. Employment. Generally payments for employment received by a resident of one state are not taxed in the other state. Canadian Treaty, Art. XV(1). If the employment was exercised in the other state, then the payments are taxed in the other state (and not the employee's state of residence) if the remunerations exceed $10,000 in the other state's currency or the taxpayer was present in the other state for more than 183 days during any 12 month period, the employer is a resident of the other state, and the payments come from a "permanent establishment" of the employer in the other state. Canadian Treaty, Art. XV(2).

H. Athletes and Artists. Income from entertainment or performing as an athlete in the other state is taxed in the other state if total payment was more than $15,000 in the other state's currency. Canadian Treaty, Art. XVI(1). This does not apply to income of an athlete competing in a league that regularly schedules games in both Canada and the United States (e.g. the NHL, NBA, MLS, and MLB). *See* Canadian Treaty, Art. XVI(3).

I. Pensions and Annuities. Pension payments or annuity payments arising from one state and paid to a resident of the other state are taxable in the other state, but any amount excluded from tax in the state where the payment arises is excluded in the other state. Canadian Treaty, Art. XVIII(1). The tax on pensions or annuities in the state where they arise is limited to 15%. Canadian Treaty, Art. XVIII(2).

1. **Social Security.** Social security payments made to a resident of the other state are taxable **only in** the other state. Canadian Treaty, Art. XVIII(5). 15% of social security payments from the United States to a Canadian resident is excluded from tax in Canada. Canadian Treaty, Art. XVIII(5)(a). The portion of social security payment from Canada that is excluded from tax in Canada is excluded from tax in the United States. Canadian Treaty, Art. XVIII(5)(b).

2. **Qualified Retirement Plans.** Subject to the qualifications below, contributions to and benefits accruing in a qualified retirement plan in one state by a resident of the other state are deductible or excludible in computing the individual's income in the other state and employer contributions are deductible in computing the individual's income in the other state. Canadian Treaty, Art. XVIII(8). These benefits are only available if the following qualifications apply:

   i. Remunerations were earned for services in and taxable in the other state;

   ii. The individual was participating in the plan immediately before performing the services;

   iii. The individual was not a resident of the other state immediately before performing the services;

   iv. The individual has performed services for the same employer in the other state for no more than 60 of the 120 months preceding the current tax year;

   v. The contributions or benefits are attributable to the services performed and made during the period when the services were performed; and

   vi. No contributions were made to a qualified retirement plan in the individual's state of residence. Canadian Treaty, Art. XVIII(8), (15)(a).

J. **Tax Credits.** Generally, tax credits or deductions are available to offset the effect of double taxation in both treaty states. *See* Canadian Treaty, Art. XXIV(1), (2).

K. **Non-Discrimination.** Generally, persons are not to be taxed in the other state in a manner that is more burdensome that the tax imposed on nationals of the other state in similar circumstances. *See* Canadian Treaty, Art. XXV.

L. **Transfer Taxes.** Article XXIX B of the Canadian Treaty includes special provisions to avoid double taxation that previously arose due to the fact that the United States Federal Estate Tax rules did not permit a credit for payment of

Canadian capital gains at death. Article XXIX B attempts to avoid that result and provides exemptions from Estate Tax for certain small Canadian estates.

1. **Estate Tax Credit.** An individual who is a Canadian resident (not a United States citizen) at his or her date of death is entitled to a unified credit against United States Federal Estate Tax equal to the greater of (i) the amount that bears the same ratio to the unified credit for a United States citizen as the value of the individual's gross estate situated in the United States bears to the individual's entire gross estate, and (ii) the unified credit of an NRA ($13,000). Canadian Treaty, Art. XXIX B(2); *see also* I.R.C. §2102(b)(3)(A) (identifying this treaty rule).

   i. Credit Use. Because the unified credit for United States citizens is currently $2,141,800, anytime a Canadian resident's United States estate is more than 0.606966% (13,000/2,141,800) of the individual's worldwide estate, he or she would be able to take advantage of this credit.

   ii. Application of Credit. Due to the way the credit applies, even though normally a United States resident's worldwide estate of $5,490,000 would be sheltered from Estate Tax, the credit shelters estates of Canadian residents that can exceed $5,490,000.

      a. For example, if a Canadian resident has a worldwide estate of $5,490,000, all of which is situated in the United States, the tentative Estate Tax would be $2,141,800 and the credit would be 100% of 2,141,800, meaning no Estate Tax is due.

      b. However, the Canadian citizen can shelter more than the Estate Tax Exclusion Amount of worldwide assets from United States Estate Tax by virtue of the way the credit under the Canadian Treaty applies. Algebraically, the value of the worldwide estate versus the United States estate that can be sheltered from United States Estate Tax can be determined under the following equation:

Worldwide Estate = U.S. Estate x [1/(Tentative Estate Tax/Unified Credit)]

Obviously, the largest United States estate a Canadian resident can have and still be sheltered from United States Estate Taxes is $5,490,000 (for 2017). Any value over that amount and the value of the worldwide estate would be irrelevant. However, if the Canadian resident has a United States estate that is less than $5,490,000, in certain circumstances he or she can still be sheltered from Estate

Tax even if his or her worldwide estate exceeds $5,490,000.

c. **For example**, if a Canadian resident has a United States estate of $4,000,000 then under the equation above he or she can have a worldwide estate equal to $5,542,244 and still be sheltered from Estate Tax in the United States. This would be calculated as follows (knowing the tentative Estate Tax on $4,000,000 is $1,545,800):

$5,542,244 = $4,000,000 x [1/($1,545,800/$2,141,800)]

The proof of this result is as follows: The tentative Estate Tax on $4,000,000 is $1,545,800, and the unified credit under the Canadian Treaty is $1,545,800 (calculated as $2,141,800 x ($4,000,000/$5,542,244)).

d. Based on the way the credit is calculated under the Canadian Treaty and the way the Estate Tax is calculated, the Canadian resident does not always end up with a large enough credit to shelter all of his or her United States estate from Estate Taxes, even if it is less than $5,490,000. **For example**, if a Canadian resident has a United States estate of $4,000,000 and a worldwide estate of $6,000,000, he or she would be entitled to a unified credit of $1,427,867 (calculated as $2,141,800 x ($4,000,000/$6,000,000)), but the tentative Estate Tax on a $4,000,000 estate is $1,545,800, leaving an Estate Tax liability of $117,933. Thus in order to shelter the United States estate from Estate Taxes the Canadian resident in this example would need other credits or deductions.

e. Consequently, knowing that Article XXIX B includes a pro rata unified credit to Canadian residents is the beginning, but not the end, of the inquiry about whether his or her estate will be subject to Estate Tax in the United States.

2. **Marital Credit.** A United States citizen or resident, or a Canadian resident, decedent may elect to either shelter property passing to a surviving spouse who is not a United States citizen by making a QDOT election for a trust qualifying as a QDOT or taking advantage of the marital credit under the Canadian Treaty. *See* Treas. Reg. §20.2056A-1(c); Canadian Treaty, Art. XXIX B(3).

i. <u>Qualification for Credit</u>. The marital credit is available if the Marital Deduction would be available but for the fact that the spouse is a non-citizen of the United States and (i) the spouse is a

resident of the United States or Canada, (ii) if both the decedent and the spouse were residents of the United States on the date of death then one or both were Canadian citizens, and (iii) the decedent's executor elects to use the marital credit and waives the benefits of the Marital Deduction on a Form 706 by the due date of a QDOT election. Canadian Treaty, Art. XXIX B(3).

ii. Amount of Credit. The marital credit is equal to the lesser of (a) the unified credit (under Art. XXIX B(2)), and (b) the Estate Tax that would be imposed in the United States on the property passing to the spouse. Canadian Treaty, Art. XXIX B(4). The Estate Tax imposed on the property is the difference between the Estate Tax with the property (before any credits) over the Estate Tax without the property (before any credits). *Id*. The marital credit is allowed after all other credits allowed by United States law.

3. **Charitable Deduction.** If a United States resident leaves property to a Canadian registered charity at his or her death, then the Canadian registered charity is treated as a United States charity for United States tax consequences. Canadian Treaty, Art. XXIX B(1)(a). If a Canadian resident leaves property to a United States charity at death, then the Canadian administrator of the estate may elect to treat the transfer as being for proceeds equal to no less than the decedent's basis and no more than the property's fair market value. Canadian Treaty, Art. XXIX B(1)(b). The effect of this is to shelter the transfer from capital gains taxes in Canada.

4. **Canadian Marital Exemption.** If a decedent was a United States resident immediately before death, both the decedent and the decedent's spouse are deemed Canadian residents for purposes of the marital exemption against Canadian capital gains. Canadian Treaty, Art. XXIX B(5).

5. **Canadian Resident Capital Gain Credit for United States Tax.** If a decedent is a Canadian resident then the decedent receives a credit against Canadian capital gains at death for (i) gains on a permanent establishment and assets related to a fixed base in the United States, (ii) any income, gains, or profits of assets in the United States if the worldwide estate exceeds $1,200,000, and (iii) income earned in the United States in the year of death and taxed in the United States. Canadian Treaty, Art. XXIX B(6)(a). There is also a credit for federal or state Estate Tax in the United States on a trust upon the death of the decedent's spouse. Canadian Treaty, Art. XXIX B(6)(b).

6. **United States Resident or Citizen Credit for Canadian Tax.** At the death of a United States resident or citizen, or his or her spouse with respect to a QDOT, a credit is allowed for Canadian taxes imposed at

death regardless of whether the identity of the taxpayer is the same under Canadian and United States law, the credit is subject to the limits under I.R.C. §2014 (treating the Canadian tax as an estate tax), and the credit can be claimed to the extent another credit is not claimed for the Canadian tax against other tax in the United States. Canadian Treaty, Art. XXIX B(7).

7. **Small Estate Exception.** If the gross value of the worldwide estate of a Canadian resident who is not a United States citizen is not more than $1,200,000 on his or her date of death then the United States may only impose Estate Tax on the United States real property or personal property forming part of a United States permanent establishment. Canadian Treaty, Art. XXIX B(8). This provision does not take into account any debts of the estate and therefore would not apply even if the net value of the estate is well below $1,200,000. *See id.*

IV. ISSUES RELATED TO UNITED STATES REVOCABLE TRUSTS. Although revocable trusts are a staple of estate planning in the United States, their use with a Canadian resident can have significant negative tax consequences.

A. Taxable Contribution. A Canadian resident's transfer of property to a revocable trust is treated as a deemed disposition of the property at its fair market value. The same result would apply to a non-resident of Canada transferring Taxable Canadian Property to a revocable trust. There would be no corresponding foreign tax credit available in the United States (because the transfer is not taxed in the United States). In addition, the revocable trust would be treated as selling all of its property every 21 years. These deemed disposition rules can be avoided if the settlor is 65 years old or older and the trust qualifies as an alter ego trust or a joint spousal trust.

B. Pour-Over Wills. Although it is common in the United States for an individual's Will to provide that any residue is to be distributed to their revocable trust (a "Pour-Over Will"), as far as the author is aware no Canadian jurisdiction has legislation recognizing the validity of Pour-Over Wills. The general Canadian rule is that a provision in a Will that permits the Will to be amended by an instrument other than a valid codicil or another Will is invalid.

C. Alternative Options. It may be better for a Canadian resident to avoid using United States revocable trusts (unless the trust qualifies for exclusion from the deemed disposition rules). One option would be for the resident to use Wills in both Canada and the United States. The Wills must be carefully drafted so they are consistent and do not contradict or revoke each other. The Canadian resident could also hold his or her United State property in a way to ensure a transfer at death outside of a trust (such as community property with right of survivorship, joint tenancy with right of survivorship, pay on death designation, transfer on death designation, or joint accounts). These options do not avoid issues related to incapacity (and the need for a conservatorship in the United States), so the Canadian resident should also have effective powers of attorney for each asset.

V. PLANNING FOR AMERICANS WITH CANADIAN CONNECTIONS.

A. **Rental Property in Canada.** Under Canadian rules and the Canadian Treaty income from renting real property in Canada may be taxed in Canada. *See* Canadian Treaty, Art. VI(1).

1. Non-resident Tax. Rental income in Canada is taxed on a gross basis (subject to tax withholdings) unless the United States resident makes an election in Canada to treat the income as if it was earned by a Canadian resident. The effect of the election is that the rental income would be taxed on a net basis at ordinary Canadian tax rates (which may or may not be less than the withholdings rate). **Therefore, it can be advantageous to make this election if the United States resident's tax in Canada on a net basis would be less than the withholding tax rate.**

2. Depreciation Recapture. If the United States resident elects to treat the rental income as earned by a Canadian resident then he or she may also take depreciation deductions on the rental property. Depreciation deductions can give rise to depreciation recapture when capital gains are triggered by sale, gift, or death. Therefore the current year tax savings on being able to take the depreciation deductions must be weighed against the long-term cost of the tax on the recapture when this election is made. It is likely that taxes saved currently are money saved in the future because of the investment potential of the saved money, but the client would need to be cognizant of the long-term tax outlook on the depreciation recapture.

3. Tax Credit Planning. Any tax paid on the triggering of capital gains from the disposition of Canadian real property may be taxed in Canada and the United States. *See* Canadian Treaty, Art. XIII(1). Capital gains on the Canadian real property at the death of the United States resident may be credited against Estate Tax. Canadian Tax, Art. XXIX B(7). If capital gains are generated by a gift, and the gift triggers a Gift Tax liability in the United States, there is not credit available under the Canadian Treaty, because it only covers capital gains and Estate Tax. Therefore, it can be critical to match the treaty benefit with the correct taxable event in order to avoid double taxation.

4. Real Estate Owning Entities. The United States resident cannot necessarily avoid the Canadian capital gain rules by owning the real property through a corporation. If the corporation's value is principally derived from Canadian real property, then the shares would be treated as Canadian real property. Canadian Treaty, Art. XIII(3)(b). The same is true of an interest in a partnership, trust, or estate the value of which is principally derived from Canadian Real Property. *Id.* In addition, personal use of the residence without paying rent to the entity could be a taxable dividend or other distribution.

5. Avoiding Capital Gains and Canadian Tax.

i. *Debt*. The simplest way to avoid Canadian tax on interest and Canadian capital gains is to hold an interest in the real property as a creditor. Under Article XI(1) of the treaty, interest paid on the note is only taxed in the state where the holder is resident. This would include interest on bonds or other securities. The interest cannot be tied to any equity kicker (such as profits or property value) if it arises from Canada, otherwise it can be taxed in Canada. *See* Canadian Treaty, Art. XI(6)(b). If the rate of tax in Canada would be better than in the United States, then taxation in Canada may be the goal.

ii. *Principally Derived Hurdle*. The other option is to hold the real property through a corporation, the value of which is not principally derived from real property. In that case, the corporation would be subject to tax in Canada, but corporate dividends can be taxed only at the lower rates of 5% (for a 10% corporate owner) or 15% for an individual owner. *See* Canadian Treaty, Art. X(2). Alternatively, the real estate could be held through a partnership the value of which is not principally derived from real property. In that case the rental income or capital gains can flow through to the owners without the two-levels of tax imposed on a corporate structure. *See* Canadian Treaty, Art. XIII(3)(b)(iii). Either of these options raises potential CFC and PFIC issues, depending on what other assets the corporation or partnership owns as well as earning stripping issues (which are beyond the scope of this outline).

iii. *Ownership by a Trust*. Although a trust would not avoid paying capital gains in Canada, from an estate planning and incapacity planning perspective a United States resident may consider creating a Canadian trust that is exempt from capital gain to hold (and acquire) the Canadian real property. Some Canadian trusts are able to distribute property prior to their 21st year in a way that the beneficiary receives a carry-over basis in the property, there is no capital gains on the distribution, and the 21-Year Rule is avoided.

6. Residency. If the United States resident owns a residence in Canada then he or she should carefully monitor connections with Canada, and days spent in Canada, to avoid unintentionally becoming a Canadian resident, if the individual's goal is to avoid taxation in Canada on his or her worldwide income.

B. Spouses. A resident of the United States owning property in Canada might consider leaving the property to a younger spouse (or into a trust qualifying for

the spousal exemption) at death in order to defer triggering capital gains until the younger spouse's death. Canadian law would allow this deferral for a Canadian resident and a Canadian resident spouse, and Article XXIX B(5) extends the benefit to United States residents. If the spouse or trust disposes of the property before the spouse's death then Canadian capital gains would be triggered with no offsetting treaty credit under Article XXIX B. If the contribution is to a trust, then the taxpayer has to consider whether Form 3520 and 3520-A come into play. If the disposition triggers Gift Tax, then there may be a mismatch between the Canadian capital gain, the Gift Tax, and the lack of provisions in the Canadian Treaty for Gift Tax relief.

C. **Retirement Accounts.** Foreign retirement accounts are not always respected in the United States as tax deferral vehicles. In addition, the underlying assets of the accounts can, in some instances, be treated as owned by the resident, causing the resident to be required to report the interests on foreign information returns. Commonly those underlying investments are treated as PFICs, because they are foreign mutual funds. The account itself is also subject to foreign information return requirements, such as FBARs and Form 8938. Foreign retirement accounts are typically not exempt trusts, like qualified plans in the United States. As such, they fall under special rules in I.R.C. §402(b). *See also* I.R.C. §402(c); Treas. Reg. §1.402(c)-1 (stating that generally a foreign trust that does no meet the requirements of a qualified plan is taxed under I.R.C. §402(b)).

1. **Canadian Retirement Plans**. Registered retirement savings plans ("RRSPs") and registered retirement income funds ("RRIFs") are automatically granted tax deferral in the United States (contributions to the plans are not excluded from income), so long as the resident files any United States tax returns during each year he or she was a United States resident, is or was a resident at any time while a beneficiary of the RRSPs or RRIFs, has not reported any undistributed accrued income in the RRSP or RRIF in his or her gross income, and he or she reported all distributions on the plan in his or her gross income (an "Eligible Individual"). *See* Rev. Proc. 2014-55, §4.01; Canadian Treaty, Art. XVIII(7). If a resident is not an Eligible Individual, then he or she cannot elect to defer the accrued income without the IRS's consent (which requires a private letter ruling). *See* Rev. Proc. 2014-55, §4.04; *see also* Treas. Reg. §301.9100-1(c) (discussing regulatory relief). **A beneficiary of an RRSP or RRIF is not required to file a Form 3520 to report contributions or distributions from the plan, but may still be required to file Form 8938 or FBARs with respect to the plan**. *See* Rev. Proc. 2014-55, §5.01. Distributions from RRSPs and RRIFs are taxed as annuities under I.R.C. §72. Rev. Proc. 2014-55, §6.

2. **Non-Eligible Individual.** If a United States resident is not an Eligible Individual, then the RRSP or RRIF is taxed under the ordinary rules of I.R.C. §402(b) discussed below. Other types of Canadian retirement accounts would also be subject to I.R.C. §402(b) rules (such as Canadian

Pension Plans, Tax-Free Savings Accounts, and Registered Pension Plans). If a non-Eligible Individual wants to make an election to defer income on a Canadian retirement plan, pursuant to Article XVIII(7) of the Canadian Treaty, he or she must obtain the IRS's consent.

i. Discriminatory Plans. If the foreign trust does not meet the requirements of a qualified plan because it does not meet the rules of I.R.C. §401(a)(26) (regarding participation percentages for defined benefit plans) or §410(b) (regarding coverage requirements for defined contribution plans and defined benefit plans), then highly compensated employees, defined in I.R.C. §414(q) (meaning a 5% owner or an employee paid at least $120,000 in the preceding year), are not allowed to defer taxes, but must include in their gross income the accretion of benefits from the plan each year to the extent the employee's interest is substantially vested. I.R.C. §402(b)(4); Notice 2016-62, 2016-46 I.R.B. 725; Rev. Rul. 2007-48.

ii. Non-Discriminatory Plans. If the plan does meet the requirements of I.R.C. §§401(a)(26) and 410(b) or the employee is not a highly compensated employee, then the plan is subject to the rules of I.R.C. §402(b) (called a "non-discriminatory plan" in this outline). Those rules provide that contributions to the plan are taxable to the employee in the year of the contribution. I.R.C. §402(b)(1).

iii. Employee Plan. If a non-discriminatory plan is an employee plan (or a non-highly compensated employee has an interest in an employee plan), then the employee may be treated as the owner of the trust property, under the grantor trust rules, and thus subject to income tax on the plan's income tax items each year. *See* Treas. Reg. §1.402(b)-1(b)(6). An "employee plan" is a plan to which the employee has contributed more to the plan than the employer. *Id*. In that case, the employee may be treated as the owner of the plan under the grantor trust rules if the employee also retained grantor trust powers (such as the ability to withdraw from the plan, the right to control the enjoyment of corpus or income from the plan, or the employee was a resident at the time of the contribution and the plan has a United States beneficiary). *Id.*; *see also* I.R.C. §§674(a), 676(a), 679(a) (stating the listed grantor trust powers).

iv. Employer Plan. If a non-discriminatory plan is an employer plan (or a non-highly compensated employee has an interest in an employer plan), then the employee would not be treated as the owner of the trust property under the grantor trust rules. *See* Treas. Reg. §1.402(b)-1(b)(6). An "employer plan" is a plan to which the employer has contributed more to the plan than the employee. *Id*. Instead, the trust's appreciation is not taxed until there is a

distribution, in which case the distribution is taxed under the annuity rules of I.R.C. §72, except distributions before the annuity starting date are included in gross income as annuity payments. *See* I.R.C. §402(b)(2). Under the usual annuity rules, an annuity payment is partly taxable and partly non-taxable. I.R.C. §72(b). The non-taxable portion is the portion previously taxed to the employee (i.e. the "investment in the contract"). *Id.* The taxable portion is the portion attributable to earnings in the contract (i.e. the "expected return under the contract"). *Id.* If the contributions were made while the employee was an NRA and the contributions came from a source outside of the United States and were not taxed in the United States, then those contributions are included in the taxable portion. I.R.C. §72(w)(1). The taxable portion also include amounts paid or accrued on the plan while the employee was an NRA and that were not subject to tax in the United States. *Id.*

v. Information Return Reporting. If the employee is a resident, then he or she would normally have to file a Form 3520 to report distributions from the plan during the year. *See* I.R.C. §6048(c), Instructions to Form 3520; *see also* I.R.C. §6048(a)(3)(B)(ii) (exempting contributions to 402(b) trusts from information return reporting). If the employee who is a resident is treated as the owner of the plan under the grantor trust rules, the he or she would need to file a Form 3520-A. I.R.C. §6048(b), Instructions to Form 3520-A. The beneficiary of a Canadian retirement plan and the plan administrator, however, are not required to file Forms 3520 or 3520-A, regardless of whether the resident is an Eligible Individual. *See* Rev. Prov. 2014-55, §5.01.

3. **PFIC Issues.** Generally, a resident would be treated as owning the resident's share of the PFIC stock of a trust in which the resident has an interest. *See* Treas. Reg. §§1.1291-1T(b)(8)(iii)(C), 1.1298-1T(b)(1)(ii). If the resident is the owner of the trust under the grantor trust rules, then the resident is treated as owning any PFIC stock of the trust. *See* Treas. Reg. §§1.1291-1T(b)(8)(iii)(D), 1.1298-1T(b)(1)(ii). The owner of the PFIC stock under these rules is required to report the PFICs each year on a Form 8621. Treas. Reg. §1.1298-1T(b)(1).

i. Exception for Nongrantor Trusts. A resident does not need to file Form 8621 reporting a nongrantor foreign trust's PFIC stock if the PFICs have not made a QEF of MTM election and the beneficiary is not treated as receiving an Excess Distribution or recognizing gain that is treated as an Excess Distribution. Treas. Reg. §1.1298-1T(b)(3)(iii).

ii. Exception for Grantor Trusts. A resident does not need to file Form 8621 reporting a grantor foreign trust's PFIC stock if the trust is a pension fund (including a pension fund that is an individual retirement plan) that is operated principally to provide pension or retirement benefits and an income tax treaty with the United States provides that income of the plan is only taxed to the resident when it is actually distribution to or for the benefit of the resident. Treas. Reg. §1.1298-1T(b)(3)(ii). The Canadian Treaty has such a provision in Article XVIII(7), but as to the United States the benefits of tax deferral in the plan must be achieved by meeting the requirements of Rev. Proc. 2014-55 (discussed above) or requesting the IRS's consent. If the taxpayer does not acquire deferral of the Canadian plan income, then arguably the provisions of Treas. Reg. §1.1298-1T(b)(3)(ii) do not apply.

4. **Transfer Taxation.** Foreign retirement accounts present a unique transfer tax challenge. Absent a provision in the Canadian Treaty preventing double taxation, they can cause significant issues. For example, the plan would be governed by foreign laws, meaning the tax apportionment elections of the resident's United States estate plan may not apply to the payees of the plan at the resident's death. If the plan is left to a non-citizen spouse, absent qualifying for the Article XXIX B(3) credit, the estate would not be eligible for a Marital Deduction unless the spouse agrees to subject to the plan to the QDOT rules and the deceased resident's executor makes a timely QDOT election. *See* Treas. Reg. §§20.2056A-2(b)(3), 20.2056A-4(c). Finally, if the person receiving the plan distributions after death is not the decedent's estate then the Canadian Treaty benefits may not be available to shelter the Estate Tax on the plan from income tax in Canada.

5. **Planning Considerations.** Clients with interests in Canadian retirement plans must carefully analyze what type of plan they own and how the particular plan is taxed. They must then consider how the plan must be reported each year on foreign information returns. Clients who have missed reported foreign plans on foreign information returns may consider exploring one of the penalty mitigation procedures (OVDP, Streamline) discussed in more detail below.

D. Outbound Investments or Transfers from the United States. The transfer of property or individuals out of the United States can have significant tax effects.

1. **Transfers to Canadian Corporations.** Aside from the FIRPTA limitations on transfers to Canadian corporations discussed above, a transfer from the United States to a Canadian corporation is typically precluded from non-recognition treatment by I.R.C. §367. Although a full discussion of I.R.C. §367 is beyond the scope of these materials, suffice it to say that generally §367(a) provides that transfers by a resident to a

foreign corporation do not qualify for non-recognition treatment and §367(b) prevents non-recognition treatment for "which there is no transfer of property described in subsection (a)(1)." *See* Treas. Reg. 1.367(b)-1(a). Non-recognition treatment is typically only permitted if the transferor enters into a "gain recognition agreement" with the IRS, promising to recognize gain on the sale or exchange of the foreign stock acquired in the transfer. *See* Treas. Reg. §1.367(a)-8(c). The resident transferor also must report the contribution to the foreign corporation on Form 926, and may need to report ownership and income from the foreign corporation under other foreign information returns annually (e.g. FBAR, Form 8938, Form 5471, Form 8621).

i. <u>Resident's as Transferors</u>. Because of the special rules related to CFCs and PFICs, a resident's transfer of assets to a Canadian corporation is generally not tax advantageous unless a check-the-box election can be made to treat the corporation as a disregarded entity or a partnership. Thus, the transferor should carefully consider whether a check-the-box election can be made to avoid the CFC and PFIC rules. If the Canadian corporation is a PFIC, then the transferor should evaluate whether a QEF or MTM election would be available to avoid the penalizing ordinary PFIC rules (though this does not convert the corporation into something other than a PFIC).

2. **Transfers to Foreign Partnerships.** Although currently the United States does not treat contributions to a foreign partnership as a sale of the contributed asset, the IRS has announced plans to issue regulations that would treat those contributions as a sale. I.R.C. §721(c); Notice 2015-54. Under Notice 2015-54, regulations are to provide for a *de minimus* exception to gain recognition if the built-in gain of the property transferred to the Canadian partnership does not exceed $1,000,000 and gain recognition would also not apply if certain partnership criteria are met. §§4.02 and 4.03. Therefore it may still be possible to use a Canadian partnership without fear of gain recognition.

3. **Transfers to Canadian Trusts.** A transfer of property to a foreign nongrantor trust is treated as a sale of the property and transfers to foreign trusts may need to be reported on Form 3520. In addition, the conversion of a domestic nongrantor trust to a Canadian nongrantor trust can be treated as a deemed sale of the trust property in the United States. Also, a transfer of Taxable Canadian Property to a Canadian trust is treated as a sale of the property in Canada. The Canadian rules also may make it disadvantageous to use a Canadian trust to hold property for a United States resident beneficiary if the goal is to hold the property in the trust for more than 21 years. Therefore, without careful planning, transfers of property to Canadian trusts may not achieve the overall tax and succession goals of the client in a way that could not be better achieved in another

jurisdiction. Any use of a Canadian trust must also take I.R.C. §2104(b) into account if the United States resident is planning to become an NRA for transfer tax purposes.

E. **Expatriation.** Due to the imposition of the American Exit Tax as well as the Expatriate Tax on Covered Expatriates and their United States beneficiaries, it is critical that United States citizens giving up citizenship or long-term permanent residents giving up lawful permanent resident status plan to avoid being Covered Expatriates. Since the Covered Expatriate thresholds are three fold, the individual must nimbly avoid each of the average income, net worth, and declaration foot faults. As an initial matter, decreasing income and net worth must be dealt with. This can be accomplished by first sitting out of the workforce to reduce income on an average basis, spending down one's net worth, and making gifts. In addition, because the Exit Tax does not apply to interests held on the expatriation date in nongrantor trusts, the individual should release, if possible, powers over grantor trusts that cause the individual to be treated as the owner of the trust property under the grantor trust rules and that would cause the individual to exceed the income or net worth thresholds. Alternatively, the individual could have the trustee of grantor trusts distribute the trust assets to new trusts of which the individual is not the owner. To avoid the 30% withholding tax on future trust distributions from nongrantor trusts, the individual may also consider releasing interests in the trust that would make him or her a beneficiary of the trust. *See discussion* Section II(B). Alternatively, he or she might consider electing to be treated as selling his or her nongrantor trust interest. *Id*.

F. **Repatriation.** If a resident of the United States (for income tax purposes) who was a resident for at least three consecutive years loses his or her resident status and then becomes a resident again within three years thereafter, he or she is taxed on his or her income in the United States during the intervening non-residency years at ordinary tax rates (if that would result in a higher tax than the normal NRA rules). *See* I.R.C. §§877(b), 7701(b)(10). The repatriated resident would be taxed during the intervening non-residency on capital gains in the United States or on any income or gain from CFCs in which the resident owned 50% of the stock at any time in the two-year period before losing residency, among other penalizing rules. *See* I.R.C. §877(b), (d). Therefore, a United States resident that becomes a Canadian resident should wait at least three years before repatriating to the United States, which requires careful monitoring of the Substantial Presence Test. Plus, expatriation from Canada would subject the individual to Canadian Exit Tax.

VI. PLANNING FOR CANADIANS WITH AMERICAN CONNECTIONS.

A. **Inbound Investments in or Transfers to the United States—Generally.** A significant amount of Canadian investment is attracted to the United States market. Careful planning can avoid significant tax issues in the United States.

1. **General Structure.** Typically, it is advantageous for a Canadian NRA to invest in the United States through a foreign corporation. This is because an NRA's ownership of stock in a foreign corporation is not taxable in the United States for Estate Tax purposes and the underlying assets of the corporation are also not subject to Estate Tax. *See* I.R.C. §2104(a); CCA201003013. Although Article XXIX B of the Canadian Treaty provides a pro-rated unified credit against Estate Tax, it also requires the Canadian NRA to disclose all of his or her worldwide estate to the IRS to claim that treaty benefit. For privacy reasons, that may not be an attractive option. Therefore the Canadian NRA could consider the typical structure of creating a foreign corporation, often referred to as "personal investment companies" ("<u>PICs</u>"), or "foreign holding companies." This planning technique is illustrated in <u>**Illustration B**</u> and may also be used to avoid state or local estate or inheritance taxes.

    i. <u>PICs</u>. The Canadian NRA would create the PIC in a jurisdiction other than the United States. Due to Canada's strict rules about trust taxation, the shares may not necessarily be owned by a trust, or if they are owned in trust, the trust would have terms to avoid the 21-Year Rule. The PIC could be a Canadian holding corporation or could be owned by a Canadian holding corporation. The ownership of assets through a Canadian PIC can also be appropriate to allow for valuation planning from a Canadian tax perspective.

    ii. <u>Funding the PIC</u>. In order to avoid potential I.R.C. §2104(b) issues, it is critical that none of the assets of the PIC come from sources within the United States. If they are funded with United States assets, then I.R.C. §2104(b) may taint the assets if somehow the IRS could argue that full and adequate consideration was not given for the stock in the PIC. Triggering I.R.C. §2104(b) would cause the assets of the corporation to be included in the NRA's gross estate for Estate Tax purposes. This risk would be mitigated if the client and advisors are careful to avoid equity shifting among shareholders. Finally, in order to avoid Canadian deemed disposition rules, the PIC would often be funded with cash or assets that do not have significant built-in gains.

2. **Treaty Management.** From an Estate Tax perspective the Canadian NRA may be relying on Article XXIX B of the Canadian Treaty for overall Estate Tax relief. For less affluent Canadians this can produce real tangible benefits because he or she would have sufficient unified credit under the Canadian Treaty to shelter his or her assets situated in the United States. The downside is that his or her estate must file an Estate Tax return and Form 8833 to claim the treaty benefit and report all of his or her worldwide estate to the IRS. Therefore, in order to avoid the administrative expense of hiring competent help in the United States to

prepare and file an Estate Tax return, and to avoid disclosing the worldwide estate to the IRS, it may still be worth planning to avoid Estate Tax entirely. In addition, most techniques to avoid Estate Tax can be a means to avoid the need for estate administration (including probate) in the United States.

B. **<u>Intangible Property</u>.** A common target of Canadian investment in the United States is United States securities. Because investments in United States corporate stock (even publically traded stock) would be included in an NRA's gross estate for Estate Tax purposes, it is often advisable for those investments to be made through a PIC if the Canadian NRA is not going to rely solely on the Canadian Treaty for Estate Tax relief.

1. **Income Taxation.** Whether the PIC or the Canadian NRA directly own United States intangibles, they may be subject to FDAP on income streams from the intangibles. The Canadian Treaty reduces the tax on some forms of FDAP (e.g. dividends under Article X, royalties under Article XII), but not all. Thus, depending on the type of FDAP, the ownership of the United States intangibles may not be tax-efficient. Alternatively, the PIC or the Canadian NRA can invest in intangibles that are not subject to income tax in the United States, such as portfolio interest (like corporate bonds). I.R.C. §871(h); Canadian Treaty, Art. XI(1).

2. **Estate Tax.** Even without a PIC and the Canadian Treaty, because certain intangibles are not subject to Estate Tax, a Canadian NRA who carefully invests in the United States can still avoid being subject to Estate Tax. Thus, a Canadian NRA may deposit money in a United States interest bearing bank account (not effectively connected with a United States trade or business), may hold portfolio interest investments, and may own United States life insurance policies on the Canadian NRA's life without Estate Tax exposure (though the life insurance could be subject to tax in Canada on its accruing income). *See* I.R.C. §2105(a), (b). Of course, investments in the United States directly (and not through a PIC) must be carefully monitored to avoid Estate Tax inclusion.

3. **Gift Tax.** Canadian NRAs (not including certain expatriates) may gift intangibles free of Gift Tax, though not free of Canadian capital gains. If the transfer is to a United States resident, then it can be a way to eliminate the overall Estate Tax liability if the transfer reduces the Canadian NRA's ownership of United States assets (taxable for Estate Tax purposes) below a level that would be covered by his or her unified credit under Article XXIX B of the Canadian Treaty and does not cause the United States resident's net worth to exceed his or her $5,490,000 Exclusion Amount.

C. **<u>Tangible Personal Property</u>.** Tangible personal property that is physically located within the United States is included in the Canadian NRA's gross estate for Estate Tax purposes. *See* I.R.C. §2103; Treas. Reg. §20.2104-1(a). This does

not apply to works of art brought to the United States solely for exhibition purposes or that are loaned for exhibition purposes to a public gallery or museum, or that are at the time of the resident's death on exhibit or en route to or from an exhibit in a public gallery or museum. I.R.C. §2105(c). The gain from the sale of tangible personal property (other than personal property forming part of a the business property of a permanent establishment in the United States) is treated as occurring without the United States when the owner is a Canadian NRA, and thus escapes income taxation in the United States. I.R.C. §865(a)(2); Canadian Treaty, Art. XIII(2). Thus, the NRA might sell tangible personal property that would cause the Canadian NRA to have an Estate Tax liability and re-invest in assets that are not subject to Estate Tax.

D. **Real Property.** Canadian ownership of real property in the United States is both common and problematic. Many Canadian NRAs acquire homes in the United States as both a place to use for recreation and living and as investment opportunities. Canadian NRAs often invest in other real estate for income generation and investment purposes. Many of these interests are subject to FIRPTA.

1. **Canadian Taxation.** Article XIII(1) allows the state where real property is located to tax the proceeds from the sale of the real property. This is not an exclusive right, however. Thus, even if a Canadian NRA can exclude gain from the sale of real property in the United States, that may not necessarily shelter him or her from Canadian tax on the sale.

2. **Rental Property.** A Canadian NRA that rents a United States real property interest may elect to treat the income from the property as ECI, instead of FDAP, and may be taxed on the rental income in the United States. I.R.C. §871(d); Canadian Treaty, Art. VI(1). The election to treat the rent as ECI may only be made if the Canadian NRA in fact has income from real property during the year. Treas. Reg. §1.871-10(a). Once the election is made, the Canadian NRA provides the payor with a W-8ECI. This can be a beneficial election because it can reduce the overall tax on the rental income in the United States and it eliminates the withholding obligation on the renter.

3. **Canadian Corporation.** A Canadian corporation (e.g. a PIC) that owns an interest in United States real property and is entitled to non-discrimination treatment under the Canadian Treaty may make an election to be treated as a domestic corporation for purposes of FIRPTA. *See* I.R.C. §897(i); Treas. Reg. §1.897-3(a); Canadian Treaty, Art. XXV.

   i. Effect of Election. The election would cause the shares in the foreign corporation to potentially be treated as interests in United States real property and thus subject to FIRPTA and subjects the foreign corporation to United States taxes (waiving any treaty

benefits) on gains upon a sale or exchange of the real property. *See* Treas. Reg. §§1.897-2(b)(1), 1.897-3(c)(2), (3).

ii. Estate Tax Issues. The Code and the Regulations make it clear that the election effects the corporation's treatment under I.R.C. §§897, 1445, and 6039C only. I.R.C. §897(i)(1); Treas. Reg. §§1.897-3(a), 1.1445-7(a). Critically, neither lists the Estate Tax sections and thus presumably the election does not change the fact that the corporation is a foreign corporation for Estate Tax purposes.

iii. Contributions to Foreign Corporations. A contribution of a United State real property interest to a corporation would only qualify for non-recognition treatment (e.g. I.R.C. §351) if the transferor receives a United States real property interest in return. Treas. Reg. §1.897-6T(a)(1). A foreign-to-foreign exchange of a United States real property interest (other than stock in a United States real property holding company) would not qualify for any gain non-recognition. Treas. Reg. §1.897-6T(b)(3). This can cause problems if an NRA currently owns a United States real property interest and wants to contribute the interest to a PIC.

iv. 897(i) Election. Thus the Canadian NRA with a PIC and a previously owned United States real property interest might make an 897(i) election for the PIC so that a contribution of the real property to the PIC can qualify for non-recognition treatment. Doing so, however, subjects the PIC stock to FIRPTA and waives treaty benefits related to the sale or exchange of stock generally. *See* Treas. Reg. §1.897-3(c)(2).

4. **Owning Vacation Homes in PICs.** Although there can be Estate Tax advantages to a Canadian NRA owning a vacation home in the United States through a PIC, there can be negative income tax consequences, aside from FIRPTA. The IRS and CRA may both view the rent-free use of the vacation home as a deemed dividend. *See G.D. Parker, Inc. v. Comm'r*, T.C. Memo 2012-327 (2012). If the income from the deemed dividend is not properly reported, then penalties and interest can add onto compound the issue if the taxpayer is ever audited. Therefore, it may not always be useful to own a vacation home in a PIC.

5. **Owning Vacation Homes in Trusts.** Due to the deemed-dividend issues with corporate ownership of real property, it can be more advantageous for the Canadian NRA to own a vacation home in the United States through a Canadian trust. Doing so may allow Estate Tax avoidance if I.R.C. §2104(b) can be avoided, and if the property is sold the trust would pay capital gains in Canada in the same manner as the Canadian NRA would have paid if he or she owned the property outright. The Canadian NRA, however, would have to give up control of the trust and certain Canadian

trusts are subject to the 21-Year Rule. One advantageous option could be to have the Canadian NRA create a trust for his or her spouse. *See e.g. Gutchess v. Comm'r*, 46 T.C. 554, 557 (1966) (concluding a taxpayer's continued occupancy of a residence in trust for the taxpayer's spouse was merely incidental to the marriage and not a retained power under I.R.C. §2036).

6. **Ownership of Real Property Through LLCs.** Canada treats LLCs as corporations for its tax purposes. Therefore, there is no pass-through or disregarded treatment of the LLC in Canada, as there is in the United States (assuming the LLC does not elect to be taxed as a corporation). Under Article IV(7)(a) of the Canadian Treaty, the Canadian resident owner of a United States LLC owning real property would not be treated as having received a dividend if the real property is rented and the net rent distributed to the owner, meaning treaty benefits related to dividends will not be available. **Since rental income is taxable in the source state under the Canadian Treaty and interest is not subject to withholdings under the treaty, it can be advantageous to incorporate leverage into a transaction that uses an entity to hold real property in the United States**, as discussed below.

7. **Jointly Owned Property.** Because the Estate Tax presumption is an NRA who owns joint property with a spouse owned all of the property at his or her death, it can be useful for both spouses to carefully contribute half of the proceeds to purchase the United States real property, if it is going to be held as jointly by the spouses. For Arizona real property, it might make sense to take title as community property in order to avoid the joint property rule and take advantage of the community property rules that would treat each spouse as owning half of the house and would allow a new basis as to the entire property at the first spouse's death and the second spouse's death.

8. **Debt.** An interest in United States real property (or a United States corporation owning United States real property) that is held solely as a creditor is not a United States real property interest. Treas. Reg. §1.897-1(d)(1). If the debt instrument allows the Canadian NRA to share in the appreciation of the property or the gross or net proceeds or profits generated from the property, then it is not an interest held solely as a creditor (a so called "equity kicker"). Treas. Reg. §1.897-1(d)(2)(i). If the Canadian NRA sells a United State real property interest and carries back a note from the buyer, the note would be treated as held solely as a creditor if the Canadian NRA waives the installment method, recognizes all gain or loss in the year of the sale, and pays all taxes due on the sale. Treas. Reg. §1.897-1(d)(2)(ii)(A). An option, right of first refusal, or contract to acquire real property is an interest in real property. Treas. Reg. §1.897-1(d)(ii)(B). The right to acquire property under a mortgage or other security is not an interest in real property. Treas. Reg. §1.897-

1(d)(ii)(C). An interest rate tied to an index that is meant to reflect general inflation (e.g. Consumer Price Index), and not general changes in real property prices, is not an equity kicker and thus qualifies as an interest as a creditor. Treas. Reg. §1.897-1(d)(ii)(D). Generally, brokerage fees or trustee fees are not interests in real property. *See* Treas. Reg. §1.897-1(d)(ii)(E), (F). As a result, layering debt into a Canadian investment in United States real property can be very beneficial from an income tax perspective.

9. **Non-Recourse Debt.** The value of real property subject to non-recourse debt is reported on a Form 706 on a net basis. *See* Treas. Reg. §20.2053-7. Therefore, one option would be to simply cause the United States real property to be subject to a non-recourse debt such that the Canadian NRA's estate (and adjusted taxable gifts) is below $60,000 and thus not required to file a Form 706 (or claim a treaty benefit). *See* Instructions IRS Form 706-NA.

10. **Branch Profits Tax.** If a foreign corporation owns an interest in real property then a sale of the property can cause the foreign corporation to be subject to the branch profits tax. *See* I.R.C. §884(a). The branch profits tax is a tax of 30% on the foreign corporation's ECI (with some adjustments). *See* I.R.C. §884(a), (b). Branch profits taxes are in addition to any other ECI tax the foreign corporation has that year. I.R.C. §§884(a), 897(a)(1)(B); Treas. Reg. §1.884-1(a). Thus, often foreign corporations want to invest through United States corporations in order to avoid the branch profits tax.

11. **Planning Opportunities.** Planning for investments in United States real property depends on the motivation for the investment. If the investment is primarily to own a second home, but not necessarily to generate income or future appreciation, then planning may follow one path. If the intent is to generate a stream of income or future investment appreciation, then planning may take a different path. Both are discussed below.

    i. <u>Personal Residence</u>.

        a. *Ownership Structure*. As discussed above, ownership of a personal residence in the United States through a PIC can have negative consequences in terms of creating a deemed dividend for any rent-free use of the property. Ownership through a Canadian resident irrevocable discretionary trust may be a better option from that perspective but the Canadian NRA must give up control over the trust property. Otherwise, the Canadian NRA would have the PIC own the property and would pay fair market rent (perhaps by paying all of the property's expenses directly).

b. *Outright Ownership*. The Canadian NRA could own the property outright, thus avoiding deemed-dividend issues. In that case he or she would be relying on the Canadian Treaty to shelter the property from Estate Tax. Obviously, careful analysis of his or her worldwide estate is necessary to ensure an appropriate Estate Tax result if relying on the treaty. If the Canadian NRA owns the property outright then he or she might consider executing a United States Will to cover disposition of the property at his or her death.

c. *Partnerships*. Alternatively, the Canadian NRA could own the United States residence through a partnership (that qualifies as a partnership in both countries) in order to ensure the same pass-through treatment in both countries. This would not necessarily avoid Estate Tax inclusion of the property in the United States, but it would allow for management of the property through the partnership during the Canadian NRA's lifetime.

ii. Income and Appreciation Goals. If the Canadian NRA wants to invest in United States real property purely for investment purposes, but not personal purposes, then a direct ownership in real property might not be appropriate.

a. *Debt.* In order to avoid the branch profits tax, FIRPTA, Estate Tax consequences of owning United States real property, and income taxes on gains from the United States, the Canadian NRA could invest in United State real property by making loans from his or her PIC to a domestic corporation that invests in United States real property. If the loan is eligible for portfolio interest then any interest paid would not be taxed in the United States, or the loan can be crafted to be an interest held solely as a creditor to avoid FIRPTA. If the domestic corporation owns the note and deed of trust on the property, then if it must reacquire the property the NRA and PIC are protected from acquiring a direct interest in United State real property they otherwise would acquire if they held the note and deed of trust and took the property back. If the interest on portfolio interest debt is paid to a related foreign corporation then an interest deduction may be disallowed or delayed for the domestic corporation if it does not meet certain special debt-to-equity and related party rules. *See* I.R.C. §§163(j), 267(a)(3); Treas. Reg. §1.267-3; *see also* Treas. Reg. §§5f-103-1(c), 5f.163-1 (regarding deduction limits on portfolio interest debt).

b. *Non-Portfolio Interest*. If the loan does not qualify as portfolio interest, then the PIC can make the loan directly to the real property owner (not necessarily a corporation) and seek the Canadian Treaty rule in Article XI(1) to only tax the interest in Canada. This can be a very efficient way to reduce the overall taxation of the interest payments while permitting the Canadian NRA to access the United States real estate market.

c. *PICs*. If the Canadian NRA invests through a PIC that owns a domestic C corporation owning underlying United States real property, then the PIC may avoid the branch profits tax, but the C corporation would be subject to the higher corporate tax rates instead of the lower individual capital gains rates. This structure is very common, but it can have decreased income tax benefits. Layering in appropriate debt can improve the overall tax performance of this structure by allowing the corporation to make non-dividend payments to the PIC while only subjecting the interest payments to Canadian tax. Careful consideration must be given to debt-to-equity rules in Canada and the United States, but those rules are beyond the scope of these materials.

E. Pre-Immigration Planning. A Canadian NRA contemplating becoming a United States resident must consider the significant tax compliance obligations in Canada and the United States. Several key areas can minimize issues and should be kept in mind.

1. **Spouses.** Before Canadian spouses become United States residents for transfer tax purposes, it can be beneficial for them to equalize their assets before the residence change. This is because gifts of property situated outside of the United States are not subject to Gift Tax, whereas gifts of worldwide assets by United States transfer tax residents are subject to Gift Tax and cannot qualify for the Marital Deduction if made to a non-citizen spouse. In addition, by equalizing property, the spouses can then each take advantage of their own Exclusion Amounts with respect to their Estate Tax exposure.

2. **Foreign Trusts.** The Canadian NRA can make tax-free gifts of foreign assets and United States intangibles to foreign trusts in order to avoid Estate Tax issues in the United States, but the trusts would be treated as grantor trusts to the Canadian NRA if the transfers are made within five years of becoming a resident and the trusts have United States beneficiaries. Thus, the Canadian NRA may want to ensure that transfers are either made five years before immigration or the trusts do not have United States beneficiaries, otherwise the trust income would be taxed in

the United States. The transfer to trusts may be subject to the Canadian capital gains rules.

3. **Canadian Exit Tax.** Since the Canadian NRA who becomes a resident of the United States would be subject to the Canadian Exit Tax on his or her worldwide assets, carefully liquidating assets in the lead up to the change in order to take advantage of offsetting losses can be beneficial. In addition, it is typically advantageous for the Canadian NRA to make an election under Article XIII(7) of the Canadian Treaty in order to be deemed to have sold all of the Canadian NRA's assets in the United States. This permits the Canadian NRA to obtain a new basis in the assets while permitting the Canadian NRA to shelter the gains from United States taxes due to the foreign tax credit.

4. **RRSPs and RRIFs.** Although RRSP and RRIF accounts are excluded from the Canadian Exit Tax, the Canadian who becomes a United States resident must prepare to appropriately disclose those accounts upon becoming a resident.

5. **CFCs and PFICs.** If the Canadian NRA owns interests in entities that would be taxed as CFCs or PFICs, he or she should consider gifting those interests or divesting the interests prior to immigration to the United States. The CFC and PFIC rules can be penalizing tax-wise and often make the investments substantially underperform as compared to non-CFC and non-PFIC investments. For example, the NRA could gift enough CFC stock to fall below the 10% threshold to be considered a United States shareholder. Of course, the gifts would likely be subject to Canadian capital gains, so careful consideration of the overall tax effect is important. The Canadian NRA could also sell PFIC stock and reinvest in direct shares of non-CFC corporations or in United States investments. If the Canadian NRA has a PIC, then the Canadian NRA might cause the PIC to engage in these re-investment steps and the Canadian NRA might elect to treat the PIC as a disregarded entity or a partnership, if possible and practical, in the United States. If interests in a PFIC cannot be disposed of, then the Canadian NRA should consider making a QEF election as to the PFIC to avoid the interest charge on deferral of PFIC gain and Excess Distributions under the ordinary PFIC rules.

F. **The United States as a Tax Haven**. Tax rates in Canada can be significant (ranging from marginal rates of 44.5% to as high as 54%, depending on the Province). In contrast, the maximum marginal rate in the United States would be 43.4%, when the 3.8% net investment income tax is included. Considering that some States have no State income tax, a Canadian taking up residency in the United States can, in some cases, save significant amounts of taxes by a change of residency. Any change must be done carefully to avoid a punishing Canadian Exit Tax, anti-avoidance rules in the United States on CFCs and PFICs, and the Throwback Rules. With the currently high Estate Tax Exemption, it can be

beneficial for the Canadian NRA to swap the Canadian capital gains rules (which do not generally permit an exemption from tax) for the Estate Tax (which allows a married couple to shelter close to $11 million with the added benefit of a new tax basis on all capital gains assets at each spouse's death). Thoughtful foreign tax credit planning can reduce double taxation.

G. **Foreign Nongrantor Trusts.** A foreign nongrantor trust cannot make distributions of accumulated income to a United States beneficiary without causing potentially adverse tax consequences to the beneficiary under the Throwback Rules. The Trustee cannot cure this issue by making transfers to a foreign intermediary because of the rules of I.R.C. §643(h). In order to "cleanse" a foreign trust with accumulated income the Trustee could distribute the accumulated income to a foreign beneficiary or a new foreign trust with only foreign beneficiaries. Alternatively, the Trustee might pay the accumulated income to charity. The trust agreement, of course, must permit the Trustee this kind of flexibility, which puts the onus on the drafter to carefully consider future income accumulation and how to cleanse the trust if it does accumulate income in the future. If the trust lacks this flexibility then the Trustee might explore ways to revise the trust agreement under the laws of the trust's jurisdiction or under other jurisdictions' laws if the trust can be moved to a new location without tax affect.

H. **Fixing Pre-Planning Issues.** Often, Canadian NRAs investing in the United States do so without first consulting with tax advisors in the United States. If the Canadian NRA has already acquired assets that would be subject to Estate Tax at the NRA's death, then some careful planning can alleviate the issues.

1. **Capital Gain Exclusion.** So long as the Canadian NRA was not in the United States for more than 183 days during the year (which of course would change the Canadian NRA's status as an NRA to a resident absent meeting the Closer Connection Test or a Treaty Tie-Breaker) and the capital assets are not held in a trade or business in the United States, capital gains are excluded from tax in the United States. *See* I.R.C. §871(a)(2); *see also* Canadian Treaty, Art. XIII(4) (exempting gains other than from real property or a permanent establishment from tax). **This does not apply to real property or personal property held in a permanent establishment in the United States**. *See* I.R.C. §897; Canadian Treaty, Art. XIII(4). In addition, gain from the sale of intangible personal property (meaning a patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property) (other than inventory or depreciable personal property) is excluded from United States income taxation so long as the consideration is not contingent on productivity, use, or disposition. I.R.C. §865(d)(1), (2). If goodwill is sold, it would not be taxable in the United States if it is goodwill sourced from a foreign country. I.R.C. §865(d)(3). For purposes of these §865 rules the term "NRA" means anyone other than a resident who does not have a tax home in a foreign country. *See* I.R.C. §865(g)(1)(B). Of course the sale of any assets that escape United States capital gain

treatment would not necessarily escape tax in Canada. *See* Canadian Treaty, Art. XIII(4).

2. **Re-Investment.** Proceeds from the sale of capital assets that would be subject to Estate Tax can then be re-invested in assets that would be both excluded from income tax and from Estate Tax.

3. **Gifting.** Intangible assets could be gifted to reduce the Canadian NRA's exposure to Estate Tax. Careful thought must be given to making gifts in trust in order to avoid the application of I.R.C. §2104(b), however. In addition, gifts may still trigger gains in Canada and therefore must be carefully selected and timed to limit the overall tax hit.

4. **Outbound Transfer.** Alternatively, the proceeds from the sale of the capital assets could be repatriated to Canada. The funds could then be contributed to a PIC and avoid I.R.C. §2104(b), so long as the funds contributed to the PIC are not located within the United States. Appropriate measures might also be considered to protect against any IRS claims that the transaction would be subject to the step-transaction doctrine, or other common law anti-abuse doctrines.

5. **Real Property.** If a Canadian NRA acquires a direct interest in United States real property then his or her options can be limited. The Canadian NRA generally cannot contribute the property to a PIC without triggering FIRPTA. If the Canadian NRA contributes the property to a domestic corporation it may qualify for non-recognition, but the Canadian NRA would still potentially own an interest in United States real property if the corporation is a United States real property holding corporation. If a transfer of the property could fully qualify for exclusion under I.R.C. §121, then a transfer directly to a PIC may have no FIRPTA or income tax effect though it may not escape Canadian taxation.

VII. <u>COMMON REPORTING ISSUES AND PLANNING</u>. Often unadvised clients are not aware of or cannot understand the extensive foreign information return requirements. Often they discover after the fact that they have missed foreign information return requirements and may be subject to significant civil and criminal penalties.

A. <u>Silent Disclosures</u>. Some taxpayers attempt to simply file amended returns reporting the unreported foreign income. This strategy relies on two things: first the six-year statute of limitations on FBAR penalties (which begins to run automatically) and second the IRS's inability to detect the mistake. It does not cut off the statute of limitations on the return, which remains open if other information returns were not filed. *See* I.R.C. §6501(c)(8). **This strategy is not recommended.**

B. <u>Offshore Voluntary Disclosure Program</u>. The taxpayer may be able to qualify for the Offshore Voluntary Disclosure Program ("<u>OVDP</u>"). OVDP is open to

taxpayers who are not under examination until the IRS decides to close the program. OVDP FAQ1. In OVDP the taxpayer must agree to open up the most recent eight years of tax years, pay accuracy related penalties, failure to file penalties, failure to pay penalties, a 27.5% penalty on the highest aggregate value of the foreign assets during the eight-year period in lieu of foreign information return penalties (increased to 50% if the taxpayer had accounts at certain black-listed financial institutions), and pay all unpaid taxes. OVDP FAQ7. The program makes the taxpayer compliant for the eight-year period and the IRS agrees not to prosecute the taxpayer criminally. OVDP FAQ3.

C. **<u>Streamline Filing Compliance Procedure</u>.** For taxpayers who are not concerned with criminal prosecution (because they did not act willfully), two Streamline Filing Compliance Procedures are available. In order to qualify for either program, the taxpayer must make a statement that they acted non-willfully in their non-compliance, cannot be under civil examination, must file three years of amended returns, and must file six years of delinquent FBARs. Non-willful conduct is "due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law." If the taxpayer did not have a United States abode and the individual was physically outside the United States for at least 330 full days then he or she meets the non-resident procedure and is not subject to any penalties. In addition, if the individual was physically outside of the United States for at least 330 full days in any one of the three years, the individual may also file delinquent tax returns. If the taxpayer cannot qualify for the non-resident procedure, then he or she must pay a 5% penalty on the highest aggregate amount of unreported foreign accounts and foreign financial assets for any one year of the amended returns and delinquent FBARs. The Streamline procedures do not give the taxpayer a guaranty that the IRS will not audit the returns or that the IRS will not refer the taxpayer to criminal prosecution. For a description of the Streamline program visit https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures.

D. **<u>Delinquent FBAR and International Return Submission Procedures</u>.** The IRS also permits taxpayers to file late FBARs or information returns under the Delinquent Submission Procedures. Under these procedures the taxpayer is not subject to penalty. To qualify the taxpayer must have no tax non-compliance with respect to the FBAR or foreign accounts or entities. The taxpayer also cannot be under civil or criminal examination or have been contacted by the IRS about the delinquent filing. In the case of foreign information returns, the taxpayer also needs reasonable cause for failing to file. There is no guaranty that the IRS will not audit the late-filed returns or refer the taxpayer to criminal prosecution. For a description of the Delinquent Submission Procedures visit https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures, and https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures.

E. **Planning Opportunities.** These programs are useful ways for taxpayers to become current on their international tax filing obligations. Delinquent filing should not be ignored. Under the IRS's many information sharing programs (including Article XXVII of the Canadian Treaty) and FATCA (including the Canada-U.S. Intergovernmental Agreement under FATCA, officially the "Agreement Between the Government of the United States of America and the Government of Canada to Improve International Tax Compliance through Enhanced Exchange of Information under the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital") it is becoming less and less likely that a taxpayer's international holdings will go undiscovered. Therefore it is wise for taxpayers to enter the appropriate program, pay any needed penalties, and then commence full compliance in the future.

[End]

ILLUSTRATION A

Application of I.R.C. §2104(b)

NRA retains String Provision power over Trust		
Funded with U.S. situs property?	Yes: trust is tainted	No: trust not tainted
No U.S. situs property at NRA's death	All included in gross estate	None included in gross estate
U.S. situs property at NRA's death	All included in gross estate	U.S. situs property included in gross estate

<u>ILLUSTRATION B</u>