Estates and Trusts Committee and International Taxation Committee - Estate Planning for Persons with Foreign Ties

Considerations for US Citizens and Residents with Canadian Ties

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I. Canada's Income Tax System

A. Overview

I address tax planning considerations for US citizens and US residents having economic ties to Canada. Situational awareness requires that a tax planner have a basic understanding of the Canadian tax regime.

B. Canada's Tax Regime

Individuals in Canada are subject to income tax pursuant to the Income Tax Act of Canada (the "**Income Tax Act**" or the "**Act**"), a federal statute.[1] The Income Tax Act imposes tax on both ordinary income and capital gains. The Province of Ontario does not have an independent income tax act applicable to individuals. Through a tax sharing agreement, the federal government collects an income tax against individuals on behalf of the Province of Ontario, the provincial income tax merely being expressed as a percentage of the federal income tax, as calculated. Canada's tax regime is administered as to Federal taxes by the Canada Revenue Agency (the"**Agency**") and, as to Provincial taxes, by the Province of Ontario's Ministry of Finance.

The Province of Ontario does however have its own corporate income tax statute. Therefore corporations subject to income tax under the Provincial statute must file both a Federal and a Provincial return. As a general rule, the Ontario Corporations Income Tax Act follows the rules established for Corporations under the Federal Income Tax Act. Yet, there continue to be areas in which the Federal rules and the Provincial rules do vary from each other.

1. Revised Statutes of Canada, 1985 (5TH SUPPLEMENT), AS AMENDED

C. Overriding Tax Treaties

The domestic tax legislation of a country can be overridden by a formal treaty between the country and another foreign jurisdiction. In the case of the US and Canada there exists longstanding tax treaty, originally called the 1942 Treaty. In 1980, the 1942 Treaty was replaced by an entirely new treaty, formally known as the Canada—United States Tax Convention (1980), (called the "**1980 Treaty**"). [2] The 1980 Treaty has been amended by five separate Protocols, the last being the Fifth Protocol of 1997. The 1980 Treaty refers to the parties, the United States and Canada, as the "**Contracting States**". The provisions of the Income Tax Act are overridden by the 1980 Treaty to the extent that such provisions are inconsistent with the terms of the 1980 Treaty. In analyzing any particular question I recommend that one begin with a consideration of the rules as established under the Income Tax Act and thereafter consider the terms of the 1980 Treaty, as amended by the various Protocols, to determine whether the 1980 Treaty provisions are at variance with the provisions of the Income Tax Act. If so, the provisions of the 1980 Treaty will prevail over the rules set forth in the Income Tax Act.

D. Residence - The Basis of Canadian Taxation

Unlike the United States, Canada levies income tax on the basis of residency. Residents of Canada are subject to Canadian income tax on their worldwide income. The question of a taxpayer's citizenship is not relevant in determining whether the taxpayer is subject to taxation on his or her world-wide income, except to the extent that the person's citizen is one of the many relevant factors used to determine whether or not the person is a resident of Canada for tax purposes. For the purposes of the Income Tax Act, an individual is resident in Canada if the individual is resident in accordance with the common law rules having reference to the economic and personal ties that the individual has with Canada.

Key indicators of Canadian residency include having a home in Canada, employment in Canada, as well as other factors such as participation in Canadian social service programs, citizenship, holding Canadian bank accounts, as stated above, citizenship, membership in private and public organizations in Canada and the presence in Canada of family members. All factors relating to a person's personal and economic ties are relevant, but, rarely is any single factor conclusive. The Income Tax Act deems an individual to be resident in Canada for a taxation year if that individual was present in Canada for more than 183 days in that taxation year.

Corporations incorporated in Canada after April 26, 1965, are deemed to be residents of Canada pursuant to the Income Tax Act. There are special rules for corporations incorporated before that date. A corporation not incorporated in Canada may be resident in Canada pursuant to the common law rules by virtue of its central management and control being exercised by persons resident in Canada.

Trusts and estates are treated under the common law as being resident in a Contracting State if the trustees or executors having control over the trust or estate are themselves residents in that Contracting State. The 1980 Treaty affirms that position but only to the extent that the trust or estate is taxable on its income earned in either of the Contracting States. Thus, an trust or estate that has no taxable income in the particular Contracting

2. The Canada-United States Income Tax Convention (1980) signed at Washington on September 26, 1980, and amended by five Protocols signed, respectively, on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997 and September 21, 2007.

State is not entitled to any of the benefits of the 1980 Treaty which would otherwise arise in that State.

E. Rates of Tax

Resident individuals, including the estates of deceased persons, pay income tax at the marginal rates of tax established under the Income Tax Act. Income tax rates applicable to Canadian individuals vary depending on the Province of residence. The calculation of the combined rates has become increasingly complex because of a trend toward lack of integration in the rate thresholds. For the 2013 tax year, individuals are subject to a combined Federal and Provincial tax rate varying from a low of approximately 20% on ordinary income to a maximum of approximately 46% (up to 49%) in Ontario), the maximum rate being achieved for taxable income in excess of approximately $135,000.00. *Inter vivos* are liable to tax on income at the top marginal rate applicable to individual taxpayers.

The rates applicable to Canadian resident corporations have also become increasingly complex owing to the implementation of scheduled rate reductions for private corporations carrying on active business. Moreover, each of the Federal government and the Provincial government has adopted different rate reductions and have implemented these according to different time schedules. In any event rate reduction continues to be the order of the day for private corporations that carry on active businesses.

For the 2012–2013 taxation year, corporations carrying on business in Ontario are subject to a combined provincial and federal tax rate of between 25% and 26% of taxable income. There are special reduced rates of taxes for corporations engaged in manufacturing and processing and for Canadian-controlled private corporations carrying on “active business”.

Canadian controlled private corporations carrying on active business pay tax at a rate of approximately 15.5% in respect of the first $500,000 of income earned from carrying on “active business”. The definition of “active business” excludes corporations earning only passive income such as interest, dividends and capital gains. The term “Canadian-controlled” is a misnomer because a private corporation carrying on active business will be entitled to the special low rate so long as the non-resident shareholders do not own or control more than 50% of that corporation’s voting shares or exercise *de facto* control.

F. Capital Gains Taxation

Overview. A taxpayer who disposes of capital property (as opposed to property that is inventory of the taxpayer) is required to pay capital gains tax on the difference between the proceeds of disposition and the cost base of the property, as calculated pursuant to the rules of the Act. Subject to certain exceptions, capital property acquired before January 1, 1972, is deemed to have a cost base equal to the higher of the fair market value of that property on December 31, 1971 or the cost of the acquisition plus additions. Consequently, gains accruing prior to 1972 are effectively excluded from taxation. Property acquired after that date is deemed to have a cost base equal to the acquisition cost, plus additions.

One-half (1/2) of the capital gain must be brought into income and such amount is taxed at the taxpayer’s marginal rate of tax applicable under the Income Tax Act. In consequence, approximately 23% of the gain is applied against the individual’s marginal rate.

Capital losses will be measured in exactly the same way so that, for example, a disposition or a deemed disposition may produce a capital loss in the appropriate instance.

G. Contrasts with the U. S. Tax Regime

The capital gains tax rules relating to dispositions of capital property differ markedly from the U.S. rules in several ways. First, unlike the Internal Revenue Code (the "***IRC***"), the Income Tax Act provides that each taxpayer is deemed to have disposed of all his or her capital property at fair market value immediately before the taxpayer's death. Thus, the estates of all individuals are subject to capital gains tax at the marginal rate of tax applicable for the decedent's terminal year. The deemed disposition occurring at death may be deferred to the date of the death of the taxpayer's surviving spouse to the extent that the property in question is willed or otherwise assumed by the surviving spouse. Until recently, only residents of Canada could take advantage of the deferral in favour of a bequest to or other assumption by a surviving spouse. The 1980 Treaty now provides a limited opportunity for US residents to take advantage of the deferral.

Second, although neither the Federal nor Provincial governments impose any gift taxes, the Income Tax Act provides that a person who disposes of capital property to a person with whom he or she is not dealing at arms length is deemed to have received proceeds of disposition equal to the fair market value of the property and thus trigger any accrued capital gains.

Third, with certain limited exceptions, all trusts, including irrevocable living trusts, are deemed to dispose of their capital property on the twenty-first anniversary of their creation and on every twenty-first anniversary thereafter. A trust created pursuant to a will that qualifies as a "**spousal trust**" (referred to in the Income Tax Act as a "Spouse Trust") is deemed to dispose of all its capital property on the twenty-first anniversary of the death of the surviving spouse and on every twenty-first anniversary thereafter. In consequence, the deemed disposition occurring at death may be deferred to the date of the death of the taxpayer's surviving spouse. Until recently, only residents of Canada could take advantage of the spousal trust deferral. The 1980 Treaty now provides a limited opportunity for U. S. residents to take advantage of the deferral.

Last, there is no Federal or Provincial estate tax or succession duty imposed in Canada, either by the Federal government or any common law Province. The succession duty imposed by the Province of Ontario was eliminated more than twenty years ago.

In summary, death, the making of an *inter vivos* gift of capital property to a non-arms length person and the passing of a trust's twenty-first anniversary each constitute a taxable event for the purposes of Canadian capital gains tax. In each case, the estate or trust or the transferee of such capital property gets a step up in the cost base of the property to the then fair market value.

H. The Tax Clearance System

The Income Tax Act requires a purchaser of property to enquire as the residency of the vendor. If the vendor is a non-resident of Canada, the purchaser is also required to obtain a Clearance Certificate pursuant to section 116 of the Act, failing which, the Act makes the purchaser liable to pay a portion of any capital gains tax found to be due by the vendor.

The Clearance Certificate is not a document registered in any land registry office and is personal to the parties to the transaction. Nevertheless for obvious reasons, purchasers impose on their non-resident vendors the requirement of producing a Clearance Certificate. In fact, the Income Tax Act provides that, in effect, a payment by the purchaser of the vendor's tax liability constitutes a discharge of the purchaser's contractual obligation to the vendor to the extent of the payment.

II. Taxation of Non-Residents of Canada

A. Overview

Subject to the provisions of the 1980 Treaty, a U.S. resident who is employed in Canada, carries on business in Canada, disposes of Taxable Canadian Property (as defined in the Income Tax Act) or who receives passive income from Canadian sources must pay income tax on the income earned from such sources for the year. Except in the case of passive income, the tax rates imposed on these sources of income are the same progressive rates of tax applicable to Canadian resident individuals and Canadian resident corporations. Passive income is taxed at a flat rate of tax by way of a withholding tax.

The tax arising on the disposition of taxable Canadian property is a capital gains tax.

Taxable Canadian Property is defined to include, among other things:

1. real property situated in Canada;
2. capital property used by the non-resident in carrying on a business in Canada;
3. shares of a corporation resident in Canada (other than a public corporation);
4. an interest in a trust resident in Canada;
5. in certain circumstances, an interest in a partnership; and
6. interests in trusts and shares of corporations at least 50% of whose value is derived from real property situated in Canada.

Generally speaking, shares of a public corporation are not taxable Canadian property so long as the non-resident owns less than 25% of the shares of any class of such corporation.

B. Withholding Tax

Part XIII of the Income Tax Act levies a withholding tax on enumerated categories of payments (and some deemed payments) of passive income received by U.S. residents from persons resident in Canada. Withholding tax is levied on: management or administration fees, interest, estate or trust income, rents, royalties, or similar payments, alimony or child support payments, certain types of pension benefits, taxable dividends, retiring allowances, registered retirement savings plans (roughly equivalent to IRA's) and other enumerated items. Some of these types of income are discussed in greater detail below. Subject to certain elective provisions and to the provisions of the 1980 Treaty, the rate of tax levied is 25% of the gross amount of such income received, or deemed to be received, by the non-resident.

The Income Tax Act requires the Canadian resident payor to withhold the amount of tax for which the non-resident payee is liable, and to remit such tax to the Receiver General of Canada on behalf of the non-resident. The Canadian resident payor is also required to withhold the prescribed percentage of the payment without any deduction whatsoever.

C. Withholding Tax on Interest Earned

Most interest payments are subject to Canadian withholding tax. However, note that interest payable on various bonds, debentures and mortgages of the Government of Canada or of a Province of Canada are exempt from withholding tax. The Income Tax Act also exempts interest paid on U.S. dollar accounts established in Canada so long as the payor and the recipient are dealing at arms length. These last mentioned provisions were no doubt enacted for the purposes of attracting foreign currency deposits in Canada.

D. Rent from Real Property

Non-residents of Canada must pay withholding tax at the rate of 25% on income received from real property situated in Canada. This rate is levied on the gross amount of the rent without permitting the non-resident any deduction whatsoever. However, a provision of the Income Tax Act permits a non-resident to elect to file income tax returns in relation to income earned from the real property as if the non-resident was in fact a resident of Canada. In the result, the non-resident person will be entitled to deduct such items as the statutory allowances for depreciation and other items of expense incurred for the purpose of earning income from the real property.

E. Pensions and Similar Payments

The Income Tax Act establishes that all payments of pensions and superannuation benefits are subject to withholding, with limited exceptions. A payment attributable to services rendered by the non-resident in taxation years throughout which the non-resident was neither resident nor employed in Canada constitutes one of the exceptions.

III. The 1980 Treaty

A. Overview

Subsequent to Canada entering into the capital gains tax field in 1972, Canada negotiated a series of tax treaties with other countries, all based upon the model treaty created by the Organization for Economic Co-operation and Development. The last to be negotiated—and by far the most significant one at the time—is the 1980 Treaty. Although trade patterns are changing rapidly, the 1980 Treaty may well be the most important tax treaty in the world in the sense that it covers one of the largest volumes of trans-national investment and business activity. As stated above, the 1980 Treaty refers to the two countries as "**Contracting States**".

The central purpose of the 1980 Treaty is the avoidance of double taxation on the residents of a Contracting State who own property or earn income in the other Contracting State. Typically the resident's country of residence seeks to tax the earnings that arise in the other Contracting State. At the same time, the other Contracting State frequently also seeks to tax the same earnings. The avoidance of double taxation is accomplished through mechanisms that seek to integrate the two national taxation regimes. Integration is sometimes difficult to achieve because the two national tax regimes are markedly different. For example, the United States levies taxation on the basis of citizenship whereas Canada taxes on the basis of residency. Moreover, as has been stated, Canada, unlike the United States, does not levy an estate tax. Instead, Canada levies capital gains taxes at death and in connection with certain dispositions that are deemed to occur at fair market value. On the other the United States levies a gift tax on gifts between parties not dealing at arms length.

Admittedly the treaty mechanisms set forth in the original 1980 Treaty did not yield perfect integration. As a consequence, the various Protocols have been enacted over the years for the purpose of improving tax integration. The Fifth Protocol continues the efforts of the two Contracting States to achieve integration. It sets forth key improvements. Nonetheless, there will be an ongoing lack of integration in certain circumstances.

The 1980 Treaty applies to receipts of passive forms of income including dividends, interest, royalties, pensions, annuities, alimony and child support payment and capital gains from the alienation of property. The 1980 Treaty also applies to non-passive sources of income, such as income from employment and business income.

Subject to limited exceptions, the 1980 Treaty provides that any term not defined therein shall be determined by reference to the domestic tax law of the country that seeks to apply the treaty. The United States Treasury Department has issued a *Technical Explanation* to both the 1980 Treaty and the 1995 Protocol. These documents are considered authoritative in the interpretation of the 1980 Treaty and the 1995 Protocol, at least for the Agency's administrative purposes. For this purpose, Canada's Department of Finance has issued a release adopting the provisions of the Technical Explanations. However, our courts have held that the Technical Explanations are, in fact, not binding on the Canadian government. Of course the Technical Explanations are the United States Treasury Department's official guide to the 1980 Treaty for its own administrative purposes.

B. Residency

Generally speaking, the 1980 Treaty applies only to residents of the U.S. and Canada. In situations where an individual taxpayer is resident in both countries, the 1980 Treaty establishes a series of tie-breaker rules.

The tie-breaker rules provides that an individual who is resident in both Canada and the U.S. is deemed to be a resident of the country in which that individual has a permanent home available to him or her. If the individual has a permanent home in both countries or in neither country, then the individual is deemed to be resident in the country with which the individual's personal and economic relations are closer. If the country with which the individual's personal and economic relations are closest cannot be determined, then the individual is deemed to be a resident of the country in which he has a habitual abode. If the individual has a habitual abode in both or neither country, the individual is deemed to be a resident of the country of which he or she is a citizen. If the individual is a citizen of both countries or neither of them, the Canadian and U.S. taxing authorities will settle the individual's status by mutual agreement.

One has to be cautious in considering the position of a Canadian resident who is also a U.S. citizen. Some of the benefits accorded to Canadian residents under the 1980 Treaty are not extended to individuals who are also U. S. citizens.

The 1980 Treaty also establishes that the residence of corporations is determined by the common law test that uses the location of central management and control as the applicable criteria. If, as a consequence of the common law test, a corporation is deemed to be simultaneously resident in both Contracting States, then, the tie-breaker rule deems the corporation to be resident in the jurisdiction of its incorporation so long as the jurisdiction of incorporation is one of the two Contracting States. In all other cases the Canadian and U.S. taxing authorities will settle the individual's status by mutual agreement.

C. Dividends - Article X

Under the 1980 Treaty, Canada is entitled to tax dividends received by a U.S. resident from Canadian sources at the rate of 15%. However the rate is reduced to 5% in the case of dividends paid by a corporation to a U.S. resident corporation owning not less than 10% of the voting stock of the Canadian corporation. As a consequence of the Fifth Protocol, a corporation is deemed to own the stock of the paying corporation if the stock is held by the corporation in a flow-through entity (referred to in the Fifth Protocol as being "fiscally transparent"). The reduction does not apply to dividends paid to a U.S. corporation having a permanent establishment in Canada if the dividends are effectively connected with the U. S. Corporation's permanent establishment.[3]

The reduction in the rate of tax applicable to dividends is thought to be a significant concession made by the Canadian negotiators of the 1980 Treaty. The reduction in rate is obviously beneficial to the many United States Corporation that have subsidiaries in Canada.

D. Income from Real Property - Article VI

Pursuant to the withholding tax provisions of the Income Tax Act, non-resident persons are required to pay an income tax at the rate of 25% on rent earned in Canada. The 1980 Treaty provides no reduction and, accordingly, the effective rate under the 1980 Treaty remains at 25% of the gross amount of all rental income earned by non-residents. As stated above, certain provisions of the Income Tax Act entitle a non-resident to file an election to be taxed on a net basis as opposed to paying tax on the gross amount of the rents received.

E. Interest - Article XI

The Fifth Protocol also initiated significant changes to the rules concerning the taxation of interest earned in a Contracting State by a resident of the other Contracting State. As a consequence, the 1980 Treaty now provides that such interest may only be taxed by other the Contracting State where the recipient resides. Thus, bank account interest and other forms of interest earned by a U.S. resident in Canada no longer be subject to taxation in Canada. However, if the interest earned by the U.S. resident is effectively connected with a permanent establishment operated by the U.S. resident, the interest may be taxed as a business profit under Article VII. Special rules will apply to interest calculated by reference to variables such as sales and profits. Such payments will continue to be taxable at a rate not exceeding 15%. Anti avoidance rules exist in the case of excessive interest paid as between payors and payees that do not deal at arms length.

F. Royalties - Article XII

The 1980 Treaty fixes the maximum withholding rate on royalties at 10% of the gross amount of the royalties in question. Copyright royalties in respect of the production or reproduction of literary, dramatic, musical, or artistic work (excluding motion pictures,

3. Article V defines the term "permanent establishment". Basically, a permanent establishment is a place of business. The 1980 Treaty provides a number of defined exclusions from properties that would otherwise constitute places of business.

films or video tape and television production) are taxable only in the country of the recipient's residence.

The term "royalties" includes the items mentioned in the immediately preceding paragraph and payments in connection with any patent, trademark, design or model, plan, secret formula or process, and payments for the right to use tangible, personal property for information concerning industrial, commercial or scientific experience.

The Third Protocol established significant improvements in the tax treatment. Consequently, paragraph 3 now provides that four classes of royalty payments will be made entirely exempt from withholding tax:

1. Copyright royalties in respect of literary and other works (other than motion pictures, video tapes, or similar payments);
2. Computer software royalties;
3. Royalties paid for the use of, or the right to use, patents and information concerning industrial, commercial and scientific experience (other than payments in connection with rental and franchise agreements); and
4. subject to the exchange of diplomatic notes between the Contracting States, payments in respect of certain live broadcast transmissions.

G. Pensions and Annuities - Article XVIII

The Fifth Protocol will grant much needed relief in the case of persons who reside in one of the Contracting States and who commute to work in the other Contracting State. Currently, a person who may have a retirement plan in the country of employment is taxable in the country of residence on payments made by the employer into a retirement plan qualified under the tax law of the country of employment. This is because the country of residence does not recognize the tax-exempt status of the retirement plan established under the law of the country of employment. Moreover, contributions made by the employee to the retirement plan are not deductible for the purposes of the tax law of the country of residence because the retirement plan is an unqualified foreign plan. Thus, a Canadian resident who commutes to the U.S. is taxable in Canada on employer contributions to the employer's U.S. pension plan. As well, if the employee makes contributions to the pension plan such contributions are not deductible for Canadian purposes.

Subject to certain limitations, the Fifth Protocol amended the 1980 Treaty to provide that the employee is entitled to deduct or exclude the amount of the contributions (Article XVIII, paragraph 10). The Fifth Protocol also seeks to facilitate the temporary transfer of employees. For example, so long as certain qualifications are satisfied, a U.S. employee who is transferred to Canada is entitled to a deduction on the employee's Canadian tax return in respect of contributions made by the employee to the employee's U.S. retirement plan during the first five years of residency in Canada.

The taxation of receipts out of pension plans and annuities has been the subject of much controversy and change in recent years, particularly with respect to the taxation of pension payments made pursuant to the social security systems of the two Contracting States.

For the purposes of the 1980 Treaty, the term “pension” includes any payment under an annuity, superannuation, pension or retirement plan, accident, sickness or disability plan. It also includes Canadian Registered Retirement Saving Plans and U.S. IRA’s. (Paragraph 3) The term “annuity” means a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make such payments. However, the term “annuity” does not include payments made for services rendered or an income averaging annuity. (Paragraph 4)

Subject to the rules concerning payment made pursuant to a Contracting State’s social security legislation, paragraph 2 provides that pension income is taxable by the country in which the pension income arises. The rate is limited to 15%. However if a former Canadian resident seeks to withdraw lump sum amounts out of a Canadian Registered Retirement Savings Plan or a Registered Retirement Income Fund, the rate of tax is increased to 25%.

Pension or annuity income arising in a Contracting State and paid to a resident of the other Contracting State may also be taxed in the state of residence, unless such income would be exempt from taxation in the Contracting State in which the income arose. A specific rule set forth in paragraph 5 provides that a benefit payable to a citizen of the U.S. pursuant to Canada’s social security legislation is taxable as though it were a benefit under the Social Security Act, except that a type of benefit that would not be taxable in Canada is exempt from U. S. taxation. Consequently, if a payment is not exempt under the Canadian social security legislation 85% of the payment will be taxable to the U. S. resident recipient according to the IRC rules.

Payments received out of Canadian Registered Retirement Savings Plans by United States residents are subject to taxation at the hands of the Canadian government at the reduced 1980 Treaty rate of 15%. The Third Protocol provided the clarification required for the purpose of confirming that the definition of “pension” includes IRAs and Canadian Registered Retirement Savings Plans and Registered Retirement Income Funds.

Paragraph 6 deals with alimony and child support payments. These types of payments are only taxable by the country in which the recipient resides. However, if the payment would be exempt from income in the Contracting State in which the payment arose then the payment will not be taxable in the State of residence. Currently, child support payments are not taxable in Canada but spousal support payments are taxable. Accordingly, a U. S. resident recipient will pay U. S. tax only on spousal support payments.

H. Gains from the Alienation of Real Property - Article XIII

Overview

Each Contracting State has the right to tax the gains of residents of the other Contracting State arising from the “alienation” of real property situated in the first mentioned Contracting State. Thus, for example, Canada has the right to tax gains of non-residents from the “alienation” of real property situated in Canada. (Paragraph 1) The Technical Explanation states that the term “alienation” includes sales, exchanges and other dispositions (including deemed dispositions) that are taxable under the taxation laws of the State seeking to apply the 1980 Treaty provisions.

Gains of U. S. residents from the alienation of personal property having a Canadian *situs* are only taxable by Canada if they form part of the business property of a permanent establish of the U.S. resident in use at the time of alienation or within the 12 preceding months. (Paragraph 2) The rule is the same for Canadian residents who alienate personal property having a U.S. *situs*. Paragraph 5 also permits Canada to tax the alienation of personal property by a U. S. resident if the person is a former long term resident of Canada.

A review of paragraph 3 (b) discloses that, for U. S. residents, the term "real property" is defined to include shares of Corporations and interests in partnerships whose value is derived principally from real property situate in Canada. Currently, Canada defines real property to include shares of Canadian corporations if more than 50% of the fair market value of the shares is derived directly or indirectly from real property situated in Canada. Were it not for this definition then the sale of shares of a Canadian real estate company would be exempt from Canadian taxation on the basis that the shares constitute personal property that, according to the provisions mentioned above, is not taxable in Canada.

The Fifth Protocol sets forth a new rule designed to assist Canadian residents who give up residency in Canada. By the terms of the Income Tax Act, each Canadian resident is deemed to have disposed of all his or her property at fair market value immediately before ceasing to be resident in Canada. This triggers the so-called Departure Tax. The new rule permits the Canadian resident to elect to be treated in the year and all subsequent years under U.S. law as having sold and immediately acquired the property for an amount equal to the fair market value at the time of departure. It is important that such election be made otherwise the former Canadian resident could be taxable in the U.S. in respect of gains that accrued during the time in which the person was resident in Canada. There is already a similar election available (subject to the discretion of the appropriate Contracting State) in connection with reorganizations that are tax-free only in one of the Contracting States.

I. The Deemed Disposition of Real Property at Death - Article XXIX-B

1. **The Deemed Disposition at Death.** As stated in the introduction, under the Income Tax Act, taxpayers are deemed to have disposed of all of their capital property at fair market value immediately before death. The deemed capital gain subject to taxation is the difference between the taxpayer's cost base and the deemed fair market value proceeds. One-half (1/2) of the gain (the "taxable gain") is subject to taxation.
2. **The Missing Tax Credit at Death.** Paragraph 7 of Article XIII provides a rule for the purpose of co-ordinating Canadian and U.S. taxation in circumstances where the tax rules of one country deems a taxable alienation of property to occur but the other country's rules do not deem a taxable alienation. In such circumstances, if the other country defers, *but does not forgive*, the taxation then the resident of that country is entitled to file an election to be liable for income tax in such other country as if the resident had sold and repurchased the capital property at fair market value. Thus, the resident will have an income tax liability against which the resident can claim a credit for the income tax payable in respect of the elected taxable alienation in the other country. For example, this provision would apply to a U.S. resident who has made a gift of Canadian real property. Canada deems the gift to be a taxable event whereas the U.S. rules simply defer taxation

by providing that the donee of the gift assumes the donor's cost base of the gifted property.

The U. S. Treasury's Technical Explanation to the 1980 Treaty takes the position that the co-ordinating rule does not apply in the case of death because, although Canada deems death to be a taxable event, the U.S. in effect forgives income taxation of the economic gains at death inasmuch as the beneficiary gets a step-up in cost base without the imposition of any U. S. capital gains tax whatsoever. It is the U.S. position that such a step-up in cost base constitutes a forgiveness of tax. In the result, the U.S. estate will be left with a Canadian tax liability with no corresponding United States income tax liability against which it can apply a credit for Canadian taxes paid.

However, the Fifth Protocol will come to the rescue. It amends Paragraph 7 of Article XIII by deleting the phrase "and the domestic law of the other Contracting State as such time defers (but does not forgive) taxation".

3. **The Third Protocol Increases the Integration of the Two National Tax Regimes**

Our respective governments recognized the injustice of failing to provide an offsetting credit as between Canadian capital gains tax liability imposed under the Canadian Income Tax Act and Federal Estate Tax liability imposed pursuant to the U.S. Federal Estate Tax. Consequently, the Third Protocol was enacted for the purpose of seeking to address this troublesome lack of integration. The results are not always perfect but they do significantly reduce the element of double taxation faced by the residents of Canada and the United States.

Article 19 of the Third Protocol (incorporated into the 1980 Treaty as Article XXIX-B) has the following important effects:

a. Under paragraph 2, Canadian residents (who are not U.S. citizens) are granted a special pro rata unified credit for the purpose of the Federal Estate Tax, calculated as follows: the greater of

(a) the credit allowed under U.S. law to a U. S. citizen x $\dfrac{\text{value of estate having a U.S. situs}}{\text{value of world estate}}$

and

(b) the credit limited to the amount of $13,000.

Unfortunately, in many cases part (a) of the formula reduces the amount of the credit because the value of the U.S. estate forms only a small part of the world-wide estate. In the result, many estates will have a credit limited to $13,000.00 or a somewhat higher amount.

b. Paragraph 3 of Article XXIX-B also allows Canadian residents a marital credit for Federal Estate Tax purposes in respect of certain transfers to a surviving spouse. This provision is intended to alleviate the harshness of the 1988 TAMRA legislation.

To qualify for the special marital credit, five conditions must be satisfied:

- the property must pass to the surviving spouse and must be property that would have qualified for the estate marital deduction under U.S. domestic law (if the surviving spouse had been a U.S. citizen and all appropriate elections had been made).
- the decedent must have been, at the time of death, either a resident of Canada or the United States or a citizen of the United States.
- the surviving spouse must have been, at the time of the decedent's death, a resident of either Canada or the United States.
- if both the decedent and the surviving spouse were residents of the United States at the time of the decedent's death, at least one of them must have been a citizen of Canada.
- the executor of the estate must irrevocably waive the benefits of any estate marital deduction which would have been allowed under U.S. domestic law. This last mentioned condition has the effect of limiting the benefits of the special marital credit to relatively small estates (see the discussion below).

The computation of the marital credit set forth in paragraph 4 is straightforward in concept but somewhat difficult to explain in words. The calculation of the marital credit can be stated in the following mathematical terms:

marital credit = the lesser of

A (the unified credit allowed to the estate)

and

B (the amount of U.S. estate tax that would be otherwise levied on the transfer of the qualifying property to the surviving spouse)

where

B = the estate tax (before allowable credits) that would be included if the qualifying property were included in the computation of the taxable estate *minus* the estate tax (before allowable credits) that would be imposed if the qualifying property were not so included.

Certain additional qualifiers are referred to in the text of Article XXIX-B and are explained in the Technical Explanation. The Technical Explanation also sets forth five numerical examples for the assistance of anyone seeking to interpret the meaning of the provisions.

c. The first important change for United States residents is set forth in paragraph 5 of Article XXIX-B. Recall that by virtue of the Income Tax Act, the U.S. resident is deemed to have disposed of all his or her capital property situated in Canada immediately before death. Paragraph 5 provides that the U.S. resident's estate can now obtain a deferral of the Canadian capital gains tax otherwise imposed on death. The deferral will apply to any property that the United States resident leaves to his or her spouse directly or to a trust that qualifies as a *Spousal Trust* pursuant to the provisions of the Income Tax Act. (Canadian residents have always been entitled to obtain a deferral of taxation arising as a consequence of the deemed disposition at death by using *Spousal Trusts.*)

By definition, a *Spousal Trust* is one ***created under a taxpayer's will*** and pursuant to which the spouse is entitled to receive all of the income of the trust arising before the spouse's death and no person, except the spouse, may, before the spouse's death, receive or otherwise obtain the use of any income or capital of the trust. Moreover, the property of the trust must vest in the trust within 36 months after the death of the taxpayer.

Note that the deferral accorded to *Spousal Trusts* is restricted to those that are created ***under the taxpayer's will.*** Consequently, it would appear that a spousal trust created under a revocable living trust does not qualify because a revocable living trust is not a testamentary instrument, much less a will. Although this interpretation is by no means certain, there is little doubt that the negotiators on behalf of our respective countries did not consider the widespread use of revocable living trusts (combined with pour over wills) for the purpose of U.S. estate planning. Our discussions with some of the Canadian treaty negotiators have confirmed this state of affairs.

d. Paragraph 6 states that residents or citizens of the United States are also to be allowed a credit against U.S. Federal Estate Tax liability in respect of Canadian, Federal and Provincial income taxes payable in Canada by reason of the passing of property on the death of the individual. The credit is also allowed to a Qualified Domestic Trust (a "*Q-DOT Trust*") Trust upon the passing of the individual's surviving spouse. This credit is applied according to the following rules:

   - The credit is allowable regardless of whether the identity of the Canadian taxpayer corresponds to the identity of the taxpayer for the purposes of United States law. This allowance accounts for the fact that a *Spousal Trust* is in fact a different taxpayer than the deceased's estate;
   - The amount of the credit is computed in accordance with and subject to the limitations of United States law regarding credits respecting foreign death taxes, as though the deemed capital gain taxed by Canada were a creditable tax under United States law; and
   - A credit may be claimed only to the extent that no credit or deduction is claimed in determining any other tax imposed by the United States (other than the estate tax imposed on property in a Q-DOT Trust upon the death of the surviving spouse).

e. Paragraph 6 also grants to Canadian residents and to *Spousal Trusts* created by Canadian residents, a credit for United States Federal Estate Tax or State estate or inheritance taxes imposed on property having a United States *situs.* In the case of estates having a gross value exceeding $1.2 Million, a credit is allowed in respect of U.S. estate taxes imposed whether or not the assets in question have a U.S. *situs.*

f. For the purposes of the U. S. Federal Estate Tax, the estate of an individual who was a resident or citizen of the U. S. at death is allowed a credit in respect of Canadian capital gain taxes imposed in connection with the deemed disposition of property situated outside Canada. The same credit is allowed to a Q-DOT Trust upon the death of the surviving spouse.

g. Finally, paragraph 8 of Article XXIX-B establishes that the United States may impose its estate tax upon the property of a Canadian resident only if any gain derived by the individual from the alienation of such property would have been subject to income taxation by the United States in accordance with Article 13 of the Treaty (capital gains). This rule applies only to estates having a gross value of $1.2 Million or less.

   This rule is premised on the fact that holders of modest estate should also derive protection from U.S. Federal Estate tax in the same way that they are now protected from capital gains tax in respect of the alienation of non-real estate assets, even though they may have a U.S. situs. In this regard, recall that Article 13 of the 1980 Treaty provides that the United States only has the right to impose capital gains tax on the U.S. real estate of Canadian residents. It does not have the right to tax personal property unless the personal property so alienated forms part of a permanent establishment in the United States. Paragraph 8 extends this same protection to United States Federal Estate Tax. However, the protection only applies in respect of estates having a gross value less than $1.2 Million.

J. Back to Article XIII - The Safe Start Rule

Article XIII of the 1980 Treaty also establishes a rule (referred to as the “Safe Start Rule”). The purpose of the Safe Start Rule is to exclude from taxation by Canada gains that have accrued prior to the effective date of the 1980 Treaty. Under the Safe Start Rule, where a resident of the U.S. alienates property situate in Canada that was owned by the U. S. resident on September 26th, 1980, the amount of the gain liable for taxation in Canada is reduced by the proportion of the gain attributable (on a monthly basis) to the period ending December 31, 1984.

A taxpayer is entitled to prove that a greater proportion of the gain is attributable to the period ending December 31, 1984, thus enhancing the Treaty protection. Such proof would presumably be provided by way of a valuation of the property as of December 31st, 1984. The transitional rule does not apply to residents of the U.S. who acquired residency after September 26th, 1980 or who have failed to maintain their U.S. residency continuously from that date to the date the property was alienated. The Agency has the practice of accepting informal valuations (so-called “drive-by valuations”) so long as they are provided by a member of the Canadian Real Estate Appraisers Association.

K. Limited Liability Companies (“LLC’s”) and Other Hybrid Entities

The law of Ontario, and, I believe, the laws of most of the Common Law jurisdictions of Canada, do not contemplate the formation of LLC’s.[4] Until the Fifth Protocol LLC’s could not take advantage of the 1980 Treaty because the 1980 Treaty applied only to persons that are subject to taxation. Canada took the position that because an LLC’s tax liabil-

4. Because of its French heritage, the laws of the Province of Quebec derive from the Napoleonic Code.

ity flows through to its members, the entity is not, as such, subject to taxation. Therefore the 1980 Treaty did not apply to LLC's. Consequently, an LLC that earned income in Canada may be taxable as if it were a corporation. For example, the Agency expressed the opinion that a Michigan LLC is to be treated for the purposes of the Income Tax Act as if it were a corporation. Moreover, the LLC will not benefit from any treaty reduction in tax rate.

The Fifth Protocol sought to address this lack of integration by providing that Canada now treats the LLC income as having been earned by the owners of the LLC so long as the U.S. also taxes the LLC owners on the basis that they received the income. This provision is added as part of Article IV.

L. Stock Options Granted to Employees on the Move

The Fifth Protocol provides, via an exchange of diplomatic notes, a new rule designed to protect an employee of a Contracting State who becomes a resident of the other Contracting State and who exercises stock options that were granted before the employee became a resident of the other Contracting State. If the employee exercises or disposes of the option following his or her acquisition of residency in the other Contracting State then any portion of the gain attributable to the period of time in which the employee was resident in the first mentioned State will not be subject to taxation in the other Contracting State.

The following example is taken from a Canadian Department of Finance news release: An employee of the U.S. is granted an option on January 1, 2010. The employee is transferred to Canada on January 1, 2011. On December 31, 2012, the employee disposes of the option. One-third of the gain will be treated as having arisen in the U.S.

M. Mutual Assistance in Tax Collection and Exchange of Information

Article XXVI A of the 1980 Treaty provides that under certain conditions each of the Contracting States will lend assistance to the other of them if Contracting State for the purpose of ensuring the collection of taxes and penalties owing by an individual or corporation, estate or other entity. For this purpose the assistance rendered is in the form of the usual collection rights possessed by the Contracting State as against its own residents. The key limitation is set for in paragraph 8 of the Article. It provides that no assistance shall be rendered if the revenue claim relates to a period in which the individual was a citizen of the Contracting State who receives the request for assistance. In the case of an artificial person or estate, no assistance shall be rendered if the revenue claim relates to a period in which the artificial person or estate derives its statues as such entity from the laws of the individual was a citizen of the Contracting State who receives the request for assistance.

Article XXVII provides that each of the Contracting States shall lend assistance by exchanging information they possess concerning their respective residents and citizens. In consequence of this Article, the ability of each Contracting State to obtain information has been greatly expanded.

IV. Probate Practice

A. Overview

Where an American decedent was domiciled in Michigan and left property situated in Ontario, the following rules will now apply:

(a) Property in Joint Tenancy.

Where property is held as joint tenants and not as tenants in common, each party is deemed to own an undivided interest in the whole. Thus, a death eliminates the decedent's interest and, in consequence, the survivor or survivors (if more than two) take the whole of the property. Therefore, property held in joint tenancy will go to the survivor by operation of law and without further proof other than the filing of an affidavit concerning death. This will apply whether dealing with real property or with personal property (where the situs is in Ontario) held in joint tenancy.

(b) Property of an Individual.

Where the individual dies owning the particular property then

(i) if it is real property it will have a *situs* in Ontario in which event an ancillary probate proceeding will be required.

(ii) if the property is personal property it must first be ascertained that the situs of the property is in Ontario. It may, for example, be a share of stock in a corporation incorporated in another province. If it is a share of stock in an Ontario incorporated company a transfer may be effected upon the production of the Michigan probate, duly certified. It is not necessary to take out an ancillary proceeding.

In Ontario, probate proceedings are accomplished through what is known as a "Certificate of Appointment". Effectively, this means that filing for probate or ancillary probate or ancillary administration in the prescribed form permits the Court to issue a Certificate of Appointment to the applicant or applicants (called the "Estate Trustee(s)"). If the decedent died intestate then an Ontario resident must act as the Estate Trustee Without a Will upon the nomination of the next-of-kin or the Michigan administrator, as the case may be. If the decedent died testate, leaving a non-resident individual as executor, that individual, even though a non-resident, may apply for a Certificate of Appointment With the Will upon the filing of a surety bond. If the decedent died testate, leaving a foreign corporate executor alone, then that corporate executor may not apply to take out ancillary proceedings unless the foreign corporate executor holds a license to carry on the trust business in Ontario. However, it can nominate an Ontario resident for that purpose. If the corporate executor is, for example, the Chance Bank of America, and the Chance Bank of America has an Ontario resident employee, there is no reason why the resident employee cannot make an application for a Certificate of Appointment With Will. We have adopted this practice in a number of instances involving estates in which U.S. banks or trust companies were named as estate trustee.

The Estate Trustee appointed under Ontario law is obliged to administer the estate in accordance with law. The Estate Trustee does not return to the Court for approval, as for example upon the sale of properties, etc. but does so in accordance with the requisite law. The Estate Trustee, of course, can be called to account upon a passing of accounts before the Court. For all practical purposes, the Ontario Estate Trustee reports to the domestic personal representative in Michigan. Upon disposing of the property and administering the estate, the Ontario Estate Trustee secures a release from the domestic Administrator or the beneficiaries as the case may be, files the release in the Court and secures a release of the surety bond. Thus, probate proceedings consist of applying to the Court at the beginning for the grant of a Certificate of Appointment, and applying to the Court at the end of the administration for the release of the surety bond.

Probate fees in Ontario are set at $5 per thousand of the estate value up to $50,000 and $15 per thousand thereafter. Assuming the ancillary estate has a cottage in Ontario valued at $500,000 then the probate fee payable to the Province of Ontario will be approximately $7,500. As a broad estimate, however, we would expect that the legal costs of ancillary proceedings for a simple estate would be approximately $3,500, plus probate fees and GST (the Canadian Value Added Tax). Fees could be higher depending on the nature of the matter and the complexity and time involved.

B. Eliminating the Necessity for a Certificate of Appointment

It is possible to avoid a court application for a Certificate of Appointment by the creation of joint tenancies. We have noted that where joint tenancies exist, title will automatically pass to the surviving joint tenant as a matter of operation of law. A bona fide purchaser for value need not make any further enquiry as to the right of the surviving joint tenant to hold or dispose of the title to the real property. Therefore, a Michigan individual, wishing to avoid the costs of the ancillary proceedings, can create a joint tenancy with another person, such as a spouse or child.

However, one must cautiously consider the potential consequences arising under Canada's capital gains tax regime. Recall that transfers of property that take place between non-arms length parties are deemed to occur at fair market value. Consequently, in order to avoid taxation in the case of a transfer to a spouse or child one must ensure that here is no transfer of the *beneficial title* to the property. For this purpose, the new joint tenant can sign an acknowledgement or declaration of trust confirming that the joint tenancy has been created solely for the convenience of the transferor and that the transferor retains the sole beneficial ownership. This acknowledgement is not normally registered in a land registry office in Ontario but one maintained by the owner to identify true ownership for the purposes of the Income Tax Act and, presumably, for U.S. tax purposes as well.

The acknowledgement can extend to providing that the surviving joint tenant/trustee will dispose of the real property in accordance with the requirements of the owner's will or living trust, as the case may be. Effectively, the new joint tenant is a bare trustee only.

If the new joint tenant should die before the true owner, then an affidavit respecting death would be filed in the Land Registry Office, and the true owner could then execute a new deed of conveyance to himself and new joint tenant. Consideration should also be given to the provision by the joint tenant/trustee of a power of attorney that is both durable and irrevocable. The power should authorize the true owner to execute all such deeds or documents as may be required for the purpose of transferring or otherwise dealing with the property in question. The costs associated with a joint ownership arrangement may be worth the benefit of having all matters settled in advance by way of a bare trust arrangement and avoiding the potentially onerous probate fees. It should be noted however that, as of late 2012, the government of Ontario passed legislation designed to make it more difficult for Ontario residents to avoid probate fees through the use of wills that are not probated. However, the implementing regulations have not yet been issued. It could be that joint ownership arrangements by non-residents of Ontario might become subject to the new regime, thus making joint arrangements subject to the payment of probate fees even though they are effective to transfer title.

It is true that in these circumstances the owner will not create the joint tenancy unless the owner is satisfied as to the integrity of the additional joint tenant. If the owner prefers not to create such joint tenancy, then the alternative is an application for a Certificate of Appointment which, in all the circumstances, the owner may not consider to be unduly expensive when matched against any concerns relating to integrity.

Where Ontario real property is being acquired by spouses, it is desirable that the spouses take title as joint tenants and not as tenants in common, since this gives rise to the automatic right of survivorship without the intervention of ancillary proceedings. In the past, where spouses have held title as joint tenants, and one has died, we have seen arrangements where the surviving spouse has entered into a joint tenancy with one or more of his or her children. In each instance, the survivor has decided whether or not to transfer the property as a gift. The creation of a joint tenancy without a trust would imply that the transaction is a gift. In such circumstances, depending on the difference between cost and fair market value, the transaction will trigger the capital gains tax. The other alternative is to accomplish the transaction by means of a bare trusteeship. These arrangements have been proven to be practical and workable.

V. The Revocable Living Trust and the Canadian Tax Regime

A common feature of United States tax planning involves the creation of a revocable living trust. Such a trust creates a settlement of the property upon the settlor as trustee during the settlor's life, with the trust property passing to successor trustees upon the death of the settlor.

We have often been asked what effect the creation of such a trust will have upon Canadian real estate. In our view, the settlement of property by a settlor upon himself as the initial trustee will be effective under Ontario law insofar as passing title is concerned. Ontario law would recognize the individual in these circumstances as holding the property in different capacities. Thus, a conveyance from A as settlor to A as Trustee would be a conveyance in law. However, to pass title to a beneficiary, or to sell to a third party, after death will doubtless require production of the living trust agreement. That would be necessary to establish the right to convey. If the successor trustee was a foreign trust corporation, it would probably be without capacity to convey. Thus, if one of the successor trustees is an individual, it might be appropriate for the living trust to vest successor rights to the Canadian real property in the individual co-trustee with full power to convey.

The income tax position with respect to transfer of property to irrevocable living trusts is not congenial to the ordinary tax planning undertaken in the U. S. The Agency has expressed the view that a transfer to a revocable living trust is a taxable disposition for the purposes of the Canadian Income Tax Act because the living trust is not a mere bare trust arrangement. In this regard, the Agency points to the fact that the trustee under a revocable living trust has extensive duties and discretions. Moreover, the trust inevitably has alternate beneficiaries. As well, a number of commentators in Canada have also taken the position that a transfer to a revocable living trust does in fact constitute a taxable disposition for the purposes of the Income Tax Act. Thus, it would appear that such a disposition may well be taxable notwithstanding the fact that a settlor of the trust continues to be entitled to receive all of the income under the living trust and, indeed, has a right to revoke it at any time.

It is uncertain what enforcement mechanisms could be brought to bear upon a non-resident who transfers his or her property to a revocable living trust. Certainly, if a deed were registered in respect of the transfer, then the likelihood of an audit will increase. As well, our two governments can take benefit exchange of information provisions, as provided in the 1980 Treaty. It may be that the best way to deal with Canadian real estate is by means of the bare trustee declaration referred to above.

Estates and Trusts Committee and International Taxation Committee - Estate Planning for Persons with Foreign Ties

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Outline

NON-RESIDENT ALIENS, RESIDENT ALIENS, U.S. CITIZENS; NON - U.S. SITUS ASSETS, GIFT TAX AND ESTATE TAX, U.S. TREATIES

Presented by: Gerard P. Charette of Miller Canfield, Windsor, Ontario
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Estate planning in our ever shrinking world includes: (i) individuals who are U.S. citizens and have property outside of the United States; (ii) individuals who are not U.S. citizens who live in the United States and have property in the United States and property in non-U.S. jurisdictions; and (iii) individuals who are not U.S. citizens and do not live in the United States but have property in the United States.

How does this get sorted out and what difference does it make?

The decision tree requires answers to the following questions:

1. Is/are the client, spouse or both U.S. citizens?
2. If not, is/are the client, spouse or both a U.S. resident for Estate Tax and Gift Tax purposes?
3. Does the client own assets in the United States, in a foreign jurisdiction or both?
4. What is the client's citizenship and residence if not U.S., and where is property located?
5. Is there a Treaty?

BASIC RULES

The basic U.S. Gift and Estate Tax rule is: U.S. citizens and U.S. residents are subject to tax on their world-wide assets.[1] Section 2001(a) of the Internal Revenue Code ("Code") imposes a tax on the taxable estate of every decedent who is a resident or citizen of the United States.

[1] All references are to the Internal Revenue Code of 1986, as amended.

Section 2101 of the Code imposes a tax on the transfer of the taxable estate of every decedent who is a non-resident and not a citizen. The assets subject to tax in the case of a non-resident are discussed below.

Section 2501(a) and Section 2511 of the Code impose the Gift Tax on the transfer of property by gift by an individual resident or non-resident. In the case of a non-resident, not a citizen, the Gift Tax applies only if the property is situated in the United States. The result is that residents and U.S. citizens are subject to Gift Tax on gratuitous transfers of their assets regardless of where located. There are credits for foreign taxes and treaty provisions that reduce the impact of the taxation of a citizen or resident's world-wide assets.[2]

RESIDENT

A person is a resident of the United States if at the time of death that person is not a U.S. citizen and is domiciled in the United States. The term United States as used in the Estate Tax Regulations includes only the States and the District of Columbia. A person acquires domicile by living in a place even for a brief period with no definite present intention of leaving. Residence alone is not sufficient. Residence becomes domicile if there is the intention to remain there indefinitely.[3] A non-resident decedent is a decedent who at the time of his death had his domicile outside of the United States and was not a U.S. citizen. The Gift Tax applies to citizens or residents and is imposed on gifts regardless of where the assets are located.[4]

A U.S. citizen includes an individual who is a dual citizen. A person who takes

[2] Section 2014 of the Code is entitled "Credit For Foreign Death Taxes and Section 2501 provides a limited credit for gift taxes in certain circumstances.

[3] Treas. Reg. §20.0-1(b)(1). A person who at the time of death was a resident of a U.S. possession is subject to the sub-set of rules.

[4] Treas. Reg. 25. 2501-1(a). There are special rules for residents of certain possessions, Section 2501(b) and (c) of the Code.

advantage of U.S. residence is subject to the U.S. Estate and Gift Tax regime on their world-wide assets.[5]

ESTATE TAXATION OF NON-RESIDENT ALIENS

A non-U.S. citizen who is a non-resident alien is taxed only on their U.S. situs assets.[6] Unless otherwise provided by treaty, the estate of a non-resident alien is entitled to a unified credit of $13,000. This exempts $60,000 of the estate from estate tax.

Property of a non-resident, not a citizen, considered to be located within the United States and thus taxable includes:

1. Real Property located within the United States;
2. Shares of stock issued by a domestic corporation;
3. Debt obligations of a U.S. person;
4. Debt obligations of the United States, a state, the political subdivision of a state or the District of Columbia;
5. Tangible personal property located in the United States, except for certain artwork on loan; and
6. Property situated within the United States that was transferred by the decedent within three years of death where the decedent retained an interest in the property that would result in taxation under Sections 2035 through 2038 of the Code.

Property without the United States is deemed to include:

1. Proceeds of life insurance on the life of a non-resident not a citizen;
2. A deposit with U.S. banks and savings and loan unless the deposits are effectively connected with a trade or business;
3. A deposit in a foreign branch of a U.S. bank;
4. Certain debt obligations;
5. Artwork on temporary exhibit in the U.S.; and

[5] A resident alien and a U.S. citizen are both entitled to the $5,000,000 applicable exclusion amount.

[6] Section 2101 of the Code.

6. Certain stock in a regulated investment company.[7]

Once the gross estate is determined, the Estate of a non-resident alien is entitled to certain deductions.[8] The deductions include:

1. Expenses, losses, indebtedness and taxes allocable to U.S. situs property;
2. Transfer for public, charitable and religious purposes;
3. Death taxes to the extent payable out of devise, legacy or bequest otherwise deductible for public, charitable and religious purposes reduce the transfer for public, charitable and religious purposes;
4. Property included in the estate of a non-resident not a U.S. citizen under Section 2041 of the Code (relating to powers of appointment) that is appointed to a charity is treated as a bequest and, therefore, deductible;
5. The marital deduction is not allowed unless the estate complies with the marital deduction provisions discussed below; and
6. In order for an estate to avail itself of any deduction, a non-resident not a U.S. citizen must disclose their world-wide assets.[9]

ESTATE TAX AND THE MARITAL DEDUCTION AND NON U.S. CITIZEN

If the client[10] intends to qualify a bequest to their spouse for the Estate Tax marital deduction, the citizenship of the spouse controls. If the surviving spouse is not a U.S. citizen, bequests to him or her do not qualify for the marital deduction with one exception. Residence of the surviving spouse is irrelevant. The surviving spouse must be or become a U.S. citizen.

In order to preserve the marital deduction, assets left to the surviving spouse, in excess of the applicable exclusion amount (available for residents and citizens) must be left in the form of a qualifying domestic trust (or "QDOT").[11] The basic qualifications for a QDOT are:

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[7] Section 2105 of the Code.

[8] Section 2106 of the Code.

[9] Section 2106(b) of the Code.

[10] The limitation on the Marital Deduction applies regardless of the residence or citizenship of the decedent.

[11] Section 2056(d) and Section 2056(A) of the Code.

- At least one trustee of the trust must be an individual citizen of the United States or a domestic corporation.
- No distribution, other than income or a hardship distribution, may be made from the trust unless it has the right to withhold from the distribution the tax imposed on the distribution.
- The trustee, an individual citizen of the U.S. or a domestic corporation.
- Regulations are imposed by the Treasury to ensure collection of the tax and to further define a domestic corporation or an individual U.S. citizen.
- Records must be kept in the U.S.
- There must be a QDOT election by the executor.

The tax imposed on distributions from a QDOT is cumulative. That is, the distribution, if not for hardship, is added to the estate of the decedent.[12] The Estate Tax is then recalculated and paid on the grossed up amount.

The best advice may be for the surviving spouse to become a U.S. citizen even after the spouse's death during the window period permitted provided by the QDOT provisions.[13]

The issues with the use of QDOT have caused some consternation. Some issues are:

1. If the QDOT exceeds $2,000,000 in value, a corporate trustee, bond or other security is required. An irrevocable letter of credit is acceptable.
2. The corporate trustee has to be a U.S. bank. This requirement may be difficult to meet if the QDOT does not have a U.S. situs. For example, a U.S. citizen with a non U.S. spouse with property outside of the United States because the couple live full-time in Canada.
3. Real estate, closely held businesses and similar assets may pose difficulties for a financial institution.
4. Principal distributions unless for hardship are subject to tax.
5. At the death of surviving spouse, the QDOT assets are taxed by adding them to the estate of the first spouse to die so they will be subject to the 40% estate tax.

There are also post death actions that can be taken if a QDOT was not created prior to

[12] Section 2056A(6).

[13] Section 2056(d)(4).

death. Reformation is allowed if the trust was otherwise qualified as a QDOT and the reformation is concluded in a timely manner. Before the due date of the return and in the case of a judicial proceeding it must be commenced before the due date. Property can be added to an existing QDOT.

The other option is for the surviving spouse to become a U.S. citizen before the due date and meet certain other requirements. It is also possible for the spouse to become a U. S. citizen at a later date and avoid QDOT treatment.

GIFT TAXATION OF NON-RESIDENT ALIEN

If a non-resident, not a citizen of the United States, makes a gift of assets with a situs in the United States, the gift is subject to the gift tax. The annual exclusion (currently $14,000) is available.[14] The citizenship of the donee matters if the gift is to one's spouse. The marital deduction is limited in the case of a gift to a spouse where the donee spouse is not a U.S. citizen.[15] For 2013 the amount of a gift to a non-citizen is $143,000 per year in 2013.

Gifts to a non-resident alien by a U.S. citizen or U.S. resident qualify for the $5,000,000 applicable exclusion amount and the $14,000 annual exclusion. In addition to the filing of a Form 709 by the donor, the gifts are or can be reportable by the donee on Form 3520.[16]

U.S. situs assets do not include intangible property and are:

- Shares of stock issued by a domestic corporation; and
- Debt obligations of a United States person or the United States, a State or any political subdivision or the District of Columbia

[14] Section 2503 of the Code.

[15] The gift tax marital deduction is indexed for inflation.

[16] Discussed below.

Gifts by a non-resident alien not a U.S. citizen can qualify for certain charitable deductions.[17]

In the case of gifts, there may be treaty provisions that are applicable.

GIFTS AND BEQUESTS BY NON-RESIDENT ALIENS TO U.S. CITIZENS AND RESIDENTS

Gifts and bequests received by a U.S. citizen or U.S. resident from a non-resident alien or their estate are generally not subject to tax by the U.S. However, the donee or devisee is required to file IRS Form 3520 entitled "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts," if the amount exceeds $100,000.[18] Qualified payments for medical expenses and education are not gifts.

One context for Form 3520: U.S. citizen lives in Michigan, establishes a revocable grantor trust. The person dies, the trust becomes irrevocable. The successor trustee is not a U.S. citizen and does not live in the United States.

Is the trust a foreign trust? Because a foreign trust is any trust that is not a U.S. trust the following two tests must both be met – Court test and Control test. U.S. Court needs to have primary supervision and one or more U.S. persons must have the authority to control all substantial decisions. Only if both tests are met is the trust a U. S. Trust.

[17] Section 2522(b) of the Code.

[18] Form 3520 must be filed not only by the recipient in the case of a gift but the filing requirement includes other outbound and inbound transfers. There are substantial penalties for failure to file this form. The Instructions for Form 3520 contain this note, "The recipient may be required to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts.

FOREIGN TRUST

A Foreign Trust is a defined term in Code Section 7701(a)(30)(E) and 7701 (a)(31)(B). A foreign trust is described above, that is a trust is presumed to be a foreign trust unless it meets both tests. There is no bright line test for determining what is or is not a foreign estate.

A nonresident alien can effectuate his or her estate plan by using a foreign trust. Not all jurisdictions recognize foreign trusts because a trust descended from English common law. So Canada, New Zeeland and other common law jurisdictions recognize trusts. Several non-common law jurisdictions have enacted trust law.

If the non-resident alien intends to include U.S. persons as beneficiaries, the U.S. beneficiaries are subject to U.S. reporting requirements if they receive assets directly from a non-resident alien, or a distribution from a trust. The grantor trust rules provide that a trust is disregarded for U.S. income tax purposes; therefore the non-resident alien (or U.S. taxpayer) is treated as owning the assets and trust otherwise subject to U.S. income tax. If the grantor is a non-resident alien the trust will be taxed as if all its assets were owned by that non-resident alien, even if the trust has a U.S. situs. That is, only U.S. source income is taxed.

If the foreign trust is not a grantor trust as to the foreign grantor, the U.S. beneficiaries are generally taxed on the DNI and the throwback rules may still apply.

Under Section 672(f), a foreign person will be treated as the owner of a trust, whether domestic or foreign, for U.S. income tax purposes only if: (i) either the trust is revocable by the grantor; or (ii) the only persons to whom distributions of income and principal from the trust may be made during grantor's lifetime are the grantor or the grantor's spouse.

A foreign grantor trust that is created as part of a non-resident alien's estate plan shall provide that distributions to U.S. individuals are not directly from the trust. Unless the trust is revocable, the trust instrument will permit distributions only to the grantor and the grantor's spouse in order to satisfy the grantor trust rules, and thus a distribution to a third party would be treated as a gift.

On the death of the foreign grantor, a number of complex rules will apply to determine the U.S. income taxation of distributions to U.S. persons. Although these rules are beyond the scope of this outline, suffice it to say that careful consideration will have to be given to whether the trust should remain a foreign trust or should instead become a domestic trust subject to U.S. income tax.

If a U.S. citizen or U.S. resident creates a foreign trust, the grantor trust rules continue to apply in the same fashion as those rules apply to domestic trusts. The U.S. person continues to be taxed on the trust income for each year the trust has a U.S. beneficiary. This has the effect of continually treating the trust as a grantor trust even if the grantor trust rules applicable to domestic trusts do not apply to the foreign trust.

REPORTING REQUIREMENTS

There are specific, numerous rules with onerous consequences for non-compliance that cover the reporting of gifts and distributions to U.S. persons from foreign trusts.

The Service provided guidance on the foreign trust and foreign gift reporting provisions, and those rules are expected to be incorporated into future Regulations. Until such Regulations are issued, taxpayers must comply with the Notice, even though some of the Code sections cited therein have since been repealed. Some of the key provisions applicable to U.S. beneficiaries of foreign trusts and U.S. donees of foreign gifts are as follows: If a U.S. person receives a distribution from a trust that the U.S. person knows or has reason to know is a foreign trust, they must report on Form 3520. Form 3520 applies to the following:

1. A U.S. person who received a gift or bequest from a foreign person.

2. A U.S. person who received a distribution from a foreign trust.
3. A U.S. person who is a grantor or beneficiary of a foreign trust.
4. If a foreign trust has made a loan to you or to a person related to you.
5. If you or a person related to you received the uncompensated use of trust property.
6. If you transferred property to a foreign trust.
7. If you are the executor of an estate and the decedent made a transfer to a foreign trust by reason of death.
8. If the decedent was an owner of any portion of a foreign trust immediately before death.
9. If the decedent's estate includes any assets of a foreign trust.

If a U.S. person receives gifts from a person that the U.S. person knows or has reason to know is a foreign person, such U.S. person must report such gifts on Form 3520, unless the gifts are for qualified medical or tuition expenses or are trust distributions reportable under Section 6048.

Total gifts from non-resident aliens or a foreign estate must be reported only if the amount of such gifts during the tax year exceeds $100,000, at which point each gift exceeding $5,000 must be reported. The U.S. person must aggregate gifts from foreign persons that he or she knows or has reason to know are related within the meaning of Section 643(i)(2)(B).

There are filing requirements set forth for Form TD F 90-22.1 entitled "Report of Foreign Bank and Financial Accounts" ("FBAR") and Form 8938 entitled "Statement of Specific Foreign Financial Assets." Each is a separate form that must be filed for which a taxpayer meets the relevant reporting threshold.

The FBAR must be filed by U.S. persons which include U.S. citizens, resident aliens, trusts, estates and domestic entities that have an interest in foreign financial accounts. One has a financial interest if you are the owner of record or holder of legal title. That person who is the owner of record or holder of legal title is your agent; you have a sufficient interest in the entity that meets the above criteria. You have signature authority to control the disposition of assets in the account, with exceptions. The filing amount is $10,000.

Form 8938 must be filed by certain individuals, which include U.S. citizens, resident aliens and some non-resident aliens who have an interest in certain specific foreign assets. The filing threshold is $50,000 on the last day of the tax year or $75,000 at any time during the tax year. One has an interest in an account if any income, gains, losses, deductions, credits, gross proceeds, or distributions, of the account or assets would be required to be reported, included or otherwise reflected on your income tax return.

COVERED EXPATRIATE

Having reviewed the above rules, the client says, "What does all this matter as I intend to retire, leave the U.S. altogether, take my assets out of the United States, surrender my 'Green Card,' and, therefore, none of this applies to me." There is the concept of "Covered Expatriate," which imposes an exit tax.

Section 877A of the Code, an income tax section, defines who is a Covered Expatriate. This section is a backup to the Estate and Gift Tax and affects not only the Covered Expatriate but also gifts and bequests from Covered Expatriates.

Gifts or bequests from a Covered Expatriate to a U.S. citizen or a U.S. resident can be subject to tax.[19] In the case of gifts or inheritances received from a Covered Expatriate, the exclusion of gifts and inheritance from income under Section 102 of the Code does not apply. Accordingly, any U.S. taxpayer who receives a gift or inheritance from a Covered Expatriate is required to include the value of the gift in his or her gross income. After having included the

[19] Section 2801 of the Code. Gifts and Bequests from Expatriate.

value in his or her income, the recipient takes a basis in the property equal to the value of the property. The gift or inheritance need not be included in the donee's gross income if the property was included on a timely filed Estate or Gift Tax return. The tax does not apply to property for which no Estate or Gift Tax return was filed and no return would have been required if the Expatriate had not expatriated.

A U.S. citizen or long-term resident alien becomes an Expatriate when they cease being either a U.S. citizen or a long-term U.S. resident ceases to be a lawful permanent resident of the United States. Section 877A of the Code is effective with respect to expatriation after June 16, 2008. The exit tax referred to as Mark-to-Market tax. This tax, with exceptions, imposes the tax as though there were a sale or exchange of assets when the individual becomes a Covered Expatriate.

Thus, Mark-to-Market tax does not apply to certain Expatriates who were born with dual citizenship in the U.S. and another country and U.S. citizens who relinquish their citizenship prior to reaching age 18 ½. [20]

A Covered Expatriate is an Expatriate whose average annual net income for the five tax years ending before to the Expatriation Date exceeds $124,000 (adjusted for inflation); the net worth of such individual is $2,000,000 or more on the date of expatriation or the individual fails to certify that they have met the test. They must also certify to a number of other matters such as filing Gift Tax returns, employment tax returns and other returns that may have been due.

The Mark-to-Market tax is imposed on the net unrealized gain of the property as if such property included in the estate of the Covered Expatriate at its fair market value one day prior to

[20] Section 877A(g)(4) An individual's Expatriation Date in the case of a long-term resident of the United States is the date the individual ceases to be a lawful, permanent resident of the United States. An Individual ceases to be a lawful, permanent resident, for example, when they lose their green card status through revocation or where green card status is administratively revoked or is judicially determined to have been abandoned. This status is defined in Section 7701(b)(6) of the Code which defines lawful, permanent resident. The date a U.S. citizen relinquishes their citizenship is their Expatriation Date.

their Expatriation Date.[21] Only Net Gain in excess of $600,000 (adjusted for inflation) is recognized.[22]

A Covered Expatriate may make an irrevocable election to continue to be taxed as a U.S. citizen. This defers the tax to the date of disposition of the property. A Covered Expatriate is required to waive any treaty rights that would preclude the collection of the tax if this election is made, and must provide security for the payment of the tax that would have been owed without the election. The amount of tax that would have been owed becomes a lien in favor of the U.S. on all of the Covered Expatriate's U.S. situs property.[23] The practical question is how to meet the security requirement.

The Covered Expatriate who is required to pay the Mark-to-Market tax must pay a tentative tax in the amount that would be due were the taxpayer's tax year to end on the date of expatriation, including amounts realized from the deemed sale of the taxpayer's property (the "tentative tax"). In addition, any period in which income or gain is otherwise deferred is terminated on the day prior to the date of expatriation, and any tax extension of time for payment of any tax terminates on the day prior to expatriation. The tentative tax is due on the 90th day after expatriation.

Even if the election to defer the tax is not made and the deemed sale provision applies to all property interests held by the taxpayer on the date of expatriation, there are exceptions.[24]

The immigration rules are amended to deny former citizens re-entry into the United States if the individual is not in compliance with his or her tax obligations under the expatriation

[21] Section 877A(a)of the Code

[22] Sections 877A (a)(3) of the Code.

[23] Section 877A (4).

[24] Section 877A(c).

tax, whether or not the individual's expatriation was tax-motivated.[25]

NON-RESIDENT ALIENS WHO ARE CONSIDERING MOVING TO THE UNITED STATES

The individual would consider making gifts and other gratuitous transfers prior to becoming a U.S. resident. This would include gifts to U.S. residents or citizens. If the property was not U.S. situs property, the only issue would be one of the local laws where they reside.

The individual might consider gifts or transfers to an irrevocable trust that does not have a U.S. situs. U.S. tax would not apply unless and until transfers are made to a U.S. beneficiary or the U.S. beneficiary has an interest in the trust that would not subject them to estate or gift tax.

If the Grantor wishes to retain an interest in the trust, such as a discretionary interest permitting the trustee to make distributions to the Grantor the consequences become iffy. There may also be creditor issues. The Michigan rule, for example, that transfers by a Grantor to a trust in which the Grantor has an interest is subject to Grantor's creditors.

The individual should be apprised of the Covered Expatriate rules and how to avoid being covered by the rule of an executive if there is some "gross up" that could be negotiated. That is, on exit to a low tax country at retirement, can there be a "make up" provision?

If there are insurance policies and other deferred tax devises owned by the individual, how will those be treated if the individual becomes a U. S. resident? Is the policy, in fact, insurance under U.S. tax law?

[25] Section 2801 – The IRS is permitted to disclose certain items of return information in order to comply with the new rules.

TREATIES

The following is a list of Conventions to which the United States is a party:

Australia
Austria
Canada
Denmark
Finland
France
Germany*
Greece
Ireland
Italy
Japan*
Netherlands
Norway
Switzerland
Union of South Africa
United Kingdom*

*These treaties include the Gift Tax

Treaties are based on one of two concepts, situs-based treaties and domicile-based treaties. For a discussion of treaties, see *Schoenblum*, 851 T.M. Bilateral Transfer Tax Treaties.

Any client who is a citizen or resident of one of the treaty countries or who has property in one or more of the treaty countries needs to be aware of how the treaty affects them. The Treaty takes precedent over the provisions of the Code.

CONVENTION BETWEEN CANADA AND THE UNITED STATES OF AMERICA WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

The Basis of Taxation – Canada taxes on the basis of residency and ownership of "Taxable Canadian Property." As discussed, the U.S. taxes based on citizenship, residency and ownership of U.S. property.

The Treaty is both an income tax treaty and an estate tax treaty.

The Treaty was signed on September 26, 1980 and has been amended by five protocols.

Canada does not have an estate tax. Rather, at death, with exceptions, there is an income tax imposed in Canada. This tax is referred to as a "deemed disposition" tax. See outline of Gerard P. Charette.

For citizens or residents of the United States, the Canadian taxes payable on death on Canadian situs property are a credit against the U.S. estate tax.

The Canadian tax law provides, in effect, that property left to a surviving spouse is not subject to the deemed disposition tax. Property left to a surviving spouse in a spousal trust which is exclusive for the spouse's benefit is not subject to the deemed disposition tax. A spousal rollover trust must be established under a Will. This can be used in conjunction with a marital QTIP or QDOT.

A Canadian resident decedent is allowed a unified credit equal to:

$$\frac{\text{Gross value of U.S. situs assets}}{\text{Gross value of world wide assets}} \ast \text{Unified Credit}$$

There is also a small estate exemption for a person who was a resident of Canada (not a U.S. citizen resident in Canada) if the person's world wide estate at the time of death does not exceed 1.2 Million. In that case, the United States can impose its estate tax only if any gain derived by that individual from the sale of such property would have been subject to income tax in the U.S. This is limited to real property and personal property that is part of the business property of a permanent establishment. There is also available a non-refundable marital credit in addition to the unified credit.

MATTERS OF LOCAL LAW

We are all familiar with common law concepts which generally allow freedom of disposition of property. Civil law countries traditionally limit an individual's testamentary freedom. Sharia law or legal system has more in common with Civil law than with Common law.

Civil law countries typically limit the freedom to dispose of property through community property laws and forced heirship. The issue can become one of whether a U.S. court will enforce an attempt to avoid forced heirship if there is property in the United States.

Many Civil law systems are similar to the Spanish and French community property for property acquired by marriage. Forced heirship requires that property be left to children and may give a surviving spouse a share of the estate. See the Estates and Protected Individuals Code §700.2951 to 700.2959.

Since trusts are not universally recognized, there may be a need for Wills covering U.S. situs property and another for non-U.S. situs property. While easy to say, drafting has to be very carefully done so the documents, in fact, coordinate the disposition of property and the payment of tax.

As discussed in connection with transfers of Canadian property into intervivos trusts, the same unforeseen consequences can arise in Canada and the U.K., both common law jurisdictions. See Todd and Edwards, *The Pitfalls of U.S./U.K. Tax Planning - The U.S. Revocable Trust*, Probate and Property Journal, March/April, 2013 at page 60.