Standard Version

U.S. Tax Exposure: Broader Than You Can Imagine

A guide for determining U.S. tax obligations

RBC Wealth Management

There's Wealth in Our Approach.™

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Setting the Scene

Living in Canada, bordering the U.S., is like living next to an elephant. Its shadow is long and wide, and can easily impact on our daily lives. U.S. taxation is a large impact.

The U.S. tax system extends in directions that many living in Canada would be surprised to learn of. Consider the following examples of people that are likely caught by the U.S. tax system.

- Tim is a U.S. citizen living in Canada
- Hui lives in Canada but was born in the U.S.
- Terrance a Canadian citizen lives in Canada but his mother or father was born in the U.S.
- Julie is a U.S. green card holder living in Canada
- Solomon a Canadian citizen living in Canada spent over 182 days in the U.S. last year
- Carole a Canadian citizen who lives in Canada spent an average of at least 122 days in the U.S. per year over the last three years
- Mohammed a Canadian citizen who lives in Canada owns U.S. stocks or a U.S. real property

Each person in the above examples has a U.S. tax "exposure", a connecting factor to the U.S. that can lead to U.S. tax filing and/or reporting obligations the failure of which to follow could result in significant costs and consequences.

U.S. tax exposure can occur in four different ways. First, the U.S. taxes those who are U.S. citizens wherever they happen to reside. So U.S. citizens living in Canada or other countries will still be subject to U.S. taxation. Second, the U.S. taxes persons who obtain U.S. green cards or spend significant amounts of time in the U.S. Third, the U.S. taxes persons who receive certain types of income derived from sources within the U.S. and holders of certain kinds of property situated in the U.S. notwithstanding that neither of these has any other exposure to the U.S. tax system. And fourth, the U.S. tax system may even extend to persons who are not U.S. citizens and may not even live in the U.S. but are considered to be domiciled in the U.S. The concept of domicile in essence refers to persons who think of the U.S. as their permanent home regardless of where they reside.

It is entirely possible that Canadian citizens, U.S. citizens and green card holders residing in Canada... can have U.S. tax obligations.

Now consider the U.S. tax system itself. Unlike Canada, the U.S. has two separate tax regimes. The first, known as the **U.S. Income Tax** system, applies to income earned or received on an annual basis, and the second, known as the **U.S. Transfer Tax** system, applies upon gratuitous transfers of property during one's lifetime and at the time of death. Persons that reside in the U.S. permanently, or for extensive periods in a year or series of years, and in some cases, who are frequently present in the U.S. are caught by the former. U.S. citizens, whether they live in the U.S. or not, are subject not only to the former, but are also caught by the latter. Green card holders are subject to the U.S. income tax system and likely also subject to the transfer tax system. Persons domiciled in the U.S., even if they spend little or no time in the U.S., are still potentially subject to the U.S. transfer tax system.

Therefore it is entirely possible that Canadian citizens, U.S. citizens and green card holders residing in Canada, and persons that are not Canadian or U.S. citizens but are simply residing in Canada can have U.S. tax obligations. It is important to note that filing obligations in the U.S. include not only sending in annual tax returns, but filing annual information returns as well, the penalties for non-filing of which can be exorbitant.

Throughout this paper we will be pointing out situations where you or someone you know could be impacted. In these circumstances, it is very important to obtain tax advice from a U.S. tax expert.

Who is a U.S. Citizen?

Tax exposure to the U.S. is most comprehensive for a U.S. citizen, so it is important to identify who this encompasses. While most U.S. citizens are quite aware of their U.S. status, there are numerous people, many of whom reside in Canada, or perhaps in other countries, who are surprised to learn, even shocked in some cases, that they too are citizens of the U.S.

Anyone born in the U.S. is automatically a U.S. citizen. While the vast majority of those born in the U.S. have lived there for their entire lives, there are many people who were born in the U.S. and do not now live, and may never have lived, in the U.S., who nonetheless are under U.S. law U.S. citizens. The fact that one does not hold a U.S. passport has no bearing on this status. Being born in the U.S. is all that is needed to obtain U.S. citizen status, regardless of whether you – or the IRS (Internal Revenue Service) – are currently acting upon it.

Anyone born in the U.S. is automatically a U.S. citizen.

The key question for those born outside of the U.S. is whether either of your natural parents is themselves a U.S. citizen. If both are U.S. citizens who are married (different rules apply if they were not married and these are not addressed in this paper), then provided that at least one of them had at some time resided in the U.S., you too are a U.S. citizen. If only one of them is a U.S. citizen, then the length of time that he or she resided in the U.S., depending upon when he/she was born, will be determinative.

Finally, it is also important to note that if you are not a U.S. citizen, but at some time obtained, and have not formally relinquished for tax purposes a U.S. green card (i.e. simply letting the card expire is not sufficient), you are taxed in the U.S. in a similar manner as a U.S. citizen. It is important to speak to a qualified immigration lawyer to determine your U.S. status.

U.S. Income Tax

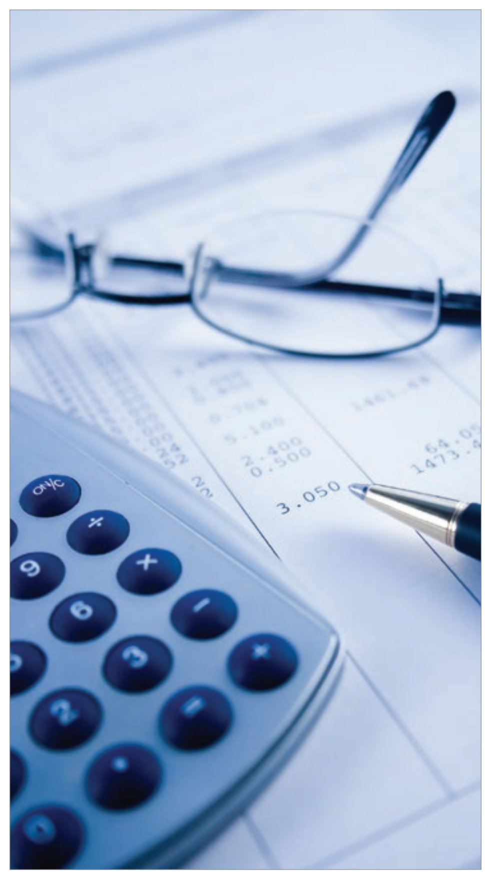
Residence Defined for U.S. Income Tax Purposes

Exposure to the U.S. income tax system arises for those who are U.S. citizens or those defined as "resident" for U.S. income tax purposes. This definition of U.S. residence covers (1) green card holders regardless of where they live, and (2) persons who are caught under what is referred to in the U.S. as the "Substantial Presence Test".

In this paper, a U.S. resident for income tax purposes will be referred to as a "U.S. Income Tax Resident".

It should be noted that U.S. green card holders living in Canada may be able to make an election under the Canada-U.S. income tax treaty under the treaty's tie-breaker rules to be considered a tax resident of Canada and a non-resident of the U.S. In doing so their green card status may be jeopardized and they may be considered to have renounced their residency status and therefore may be subject to U.S. exit tax rules. These rules are discussed later in the section "Leaving the U.S. Tax System". For purposes of this paper, U.S. green card holders will be considered to be U.S. Income Tax Residents under the U.S. income tax system i.e., they will not have made the treaty election.

The Substantial Presence Test is intended to bring within the definition of U.S. Income Tax Resident those who are in the U.S. for more than 182 days in any given year, as well as people who spend at least 122 days per year in the U.S. on average (using a specified formula) over a three year period. This catches many Canadian "snowbirds" i.e., typically Canadian citizens or residents that own or rent a home or other property in the U.S. and live in it usually over much of the winter, but can also include individuals who live in Canada but travel frequently to work in the U.S. The quick reference box summarizes the substantial presence test and may assist you in determining your status.



U.S. Income Tax *(continued)*

You ARE a U.S. Income Tax Resident – Quick reference box

You are considered a U.S. Income Tax Resident (other than a green-card holder) if you spend:

At least 183 days in the current year in the U.S.,
OR
You spend at least 31 days in the current year in the U.S. and you meet the substantial presence test:

Substantial Presence Test – Formula:

Add all the days you spent in the U.S. in the current calendar year:

plus

1/3 of the days you spent in the U.S. last year:

plus

1/6 of the days you spent in the U.S. in the year prior to last year

If when using the formula above your total equals at least 183 days, you are considered a U.S. Income Tax Resident for U.S. tax purposes in the current year.

You ARE NOT a U.S. Income Tax Resident – Quick reference box

You are not a U.S. Income Tax Resident (other than a green card holder) if you spend:

Less than 31 days in the U.S. in the current year,

OR

At least 31 days in the current year but you do not meet the substantial presence test.

Some estimates have more than 500,000 Canadian snowbirds in the U.S. If they are caught by the Substantial Presence Test in any given year, they will be considered dual residents of Canada and the U.S., subjecting them to income tax filing and reporting obligations in both countries. This situation can be addressed in any year by timely filing IRS Form 8840 whereby one is in effect agreeing that he or she has met the Substantial Presence Test in that year, but taking the position that a closer connection exists with a country other than the U.S. i.e., in this case, Canada. In such years, U.S. tax filings will not be required. Form 8840 cannot be filed by a person who has spent at least 183 days in the U.S. in the current year or a person who has applied for a permanent resident visa.

Where the Substantial Presence Test is met by spending more than 183 days in the U.S. in a year, resort can be had to the Canada-U.S. Tax Treaty by claiming closer ties to Canada based on the residency tie-breaker rules.

Similar to Canadian tax rules, anyone who lives in or spends a fair bit of time in the U.S. will likely be subject to U.S. income tax. However unlike Canada, which taxes only those who reside in our country, U.S. citizens and green card holders remain within the confines of the U.S. income tax rules even if they do not live in or spend any time in the U.S. in any given year.

It is therefore critical that the latter stay abreast of and in compliance with, U.S. tax reporting and filing requirements.

Scope of U.S. Income Tax

U.S. citizens and U.S. Income Tax Residents pay tax in the U.S. not only on their income earned in the U.S., but on income earned from around the world. Income is widely defined to include virtually all sources or types of income, and is taxed at the highest 2015 federal income tax rate of 39.6% for taxable income exceeding U.S. $413,200 (for married individuals filing jointly with their spouse in 2015).

Since 2013, U.S. citizens and U.S. Income Tax Residents that earn in excess of U.S. $250,000 (for married individuals filing jointly) of income in a year are also subject to an additional tax of 3.8% on their net investment income i.e., income such as interest, dividends, capital gains and rents, less deductible investment expenses.

There are preferential tax rates that apply to capital gains realized after a year or longer holding period, and on qualified dividends, both of which are taxed at the highest tax rate of 20%. However, for high income taxpayers the 3.8% additional tax on investment income applies to these income sources, thereby increasing their otherwise reduced rates of taxation.

U.S. citizens and U.S. Income Tax Residents that live in Canada

U.S. Income Tax *(continued)*

may well be subject to tax in both countries. In most cases double taxation is not an intended result and is generally avoided by a system of foreign tax credits (except that foreign tax credits are not available in the case of the 3.8% net investment tax). Double taxation cannot always be avoided. Furthermore, if one country taxes the same income at a higher rate than the other, the combined taxes will be at the higher rate.

Canadians Owning and Renting U.S. Real Property

Many Canadians (who are not U.S. citizens or green card holders) invest in U.S. real property in the form of a home, condominium or commercial property. In Florida alone, Canadians spent $2.2 billion in real estate in 2013 and the majority of them (53%) plan to use the real estate as a vacation property while 14% plan to use it as a rental property.[1]

In cases where rental income is generated and/or a gain upon a sale, both U.S. and Canadian income tax will apply. However, Canada generally allows a foreign tax credit for U.S. tax paid on both annual rental income, and on taxable capital gains therefore double taxation is avoided. Tax on U.S. based rental income can be paid in one of two ways. Tax can be withheld on gross rent at a flat rate of 30% or one can elect to file a non-resident U.S. tax return on a net rental basis. It generally makes sense to file on a net basis when you expect the tax on net rental income to consistently be less than 30% of the gross rental income.

The capital gain on the sale of U.S. real property will require the filing of a U.S. income tax return. Where the property is owned for more than one year, the highest U.S. tax rate of 20% applies with possible additional taxes owing in the state in which the property is located. It should be noted that U.S. withholding tax at a rate of 10% of the selling price is initially withheld. This is not the final tax. Rather it is a deposit on the ultimate tax liability shown on a required tax return. Where applicable, the withholding amount can be reduced to the actual U.S. tax owing by filing IRS Form 8288B no later than the closing date of the sale of the property.

Tax Traps for U.S. Citizens Living in Canada

There are over 7.6 million U.S. citizens living abroad.[2] Based on the 2011 Canadian Census, over 3 million are U.S. citizens living in Canada.[3] In this section they are referred to as "Americans in Canada".

Just like Canadians, they will own various types of assets, some of which will grow, produce income, and possibly receive preferential tax treatment. The difference for Americans in Canada is that they need to abide by both Canadian and U.S. tax rules, making their tax situation much more complicated.

While the system of foreign tax credits and rules under the Canada U.S. tax treaty are often helpful, there are numerous tax traps that Americans in Canada can easily fall into, sometimes with very serious consequences.

Registered Plans

Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) work for Americans in Canada as the tax deferral that Canadians enjoy until funds are withdrawn equally apply under U.S. income tax rules and while there is no deduction for U.S. income tax purposes upon contributions to RRSP plans (except for contributions to certain group RRSP plans), these contributions can be withdrawn on a U.S. tax free basis.

Tax Free Savings Accounts (TFSAs) do not work for Americans in Canada as the U.S. will tax the annual income. Also Registered Education Savings Plans (RESPs) funded by subscribers who are U.S. citizens do not work well because they are taxed annually in the U.S. on the income earned in the plan. Also, since TFSAs and RESPs are trusts, Americans in Canada who are contributors or beneficiaries may have to file complex U.S. trust information forms annually.

Canadian Retirement Plans

Americans in Canada that participate in a number of incentive, severance, nonqualified retirement income and deferred compensation plans offered by Canadian employers must consider whether these plans are subject to punitive U.S. tax rules contained in Section 409A of the U.S. Internal Revenue Code. Failure by Canadian employers to meet the requirements of Section 409A may result in immediate U.S. taxation of the deferred compensation to these American employees, plus an interest charge and an additional tax equal to 20% of the amount included in income.

Transferring U.S. Retirement Plans to Canada

Americans in Canada may have established Roth IRAs, IRAs, and 401(k) retirement plans before moving to Canada. Roth IRAs are similar to TFSAs as there are no deductions for contributions to the plan and the income and contributions may be withdrawn from the plan tax-free. Canada will provide the same tax treatment if no contributions are made while the owner of the Roth IRA is a resident of Canada and by making a one-time election under the

U.S. Income Tax *(continued)*

treaty in the first year in which you move to Canada. No further contributions may be made to the Roth IRA while they are resident in Canada.

U.S. 401(k)s and IRAs can in many cases be transferred to Canadian RRSPs on a tax-neutral basis. Although the withdrawal from these accounts are subject to U.S. taxation and potentially an additional 10% early withdrawal tax, it may be possible to obtain full foreign tax credit relief in Canada, resulting in tax neutrality. It is important to do an analysis to ensure tax neutrality since the strategy does not work for everyone.

U.S. 401(k)s and IRAs can in many cases be transferred to Canadian RRSPs on a tax-neutral basis.

Assets Held in Legal Structures

Americans in Canada may hold assets in Canadian based trust and corporate legal structures such as family trusts and family investment holding corporations.

The U.S. views these trusts and corporations as foreign legal structures, and notwithstanding that these structures are generally taxable in Canada, the U.S. may tax these structures differently under what are referred to as "U.S. based anti-deferral rules" and "U.S. foreign trust rules", potentially resulting in double taxation.

U.S. Based Anti-Deferral Rules

There are two anti-deferral tax regimes in the U.S. dealing with interests that Americans in Canada might have in foreign companies. The first regime is concerned primarily with investments in foreign investment companies such as: non-U.S. mutual funds, pooled funds and ETFs, and is referred to as the Passive Foreign Investment Company ("PFIC") rules. This regime results in taxation at the top U.S. federal tax rate of 39.6% (plus a possible interest charge) on distributions of income earned in prior years and on any gain from the sale of the shares of the PFIC itself. While the U.S. allows a foreign tax credit for Canadian taxes paid, the credit may not be sufficient to offset the U.S. tax. One simple solution to avoid the PFIC problems is to invest directly in stocks and bonds. Some foreign investment companies will provide PFIC Annual Information Statements with information enabling the investor to treat a fund as a Qualifying Electing Fund (QEF) to avoid PFIC issues. Generally, PFICs held in RRSPs and RRIFs are exempt from the PFIC rules.

The second addresses interests that Americans in Canada have in non-U.S. companies controlled by U.S. shareholders. These are referred to as the controlled foreign corporation ("CFC") rules. Americans in Canada must personally report passive income, such as dividend and interest earned in the CFC, in the year that it is earned even if this income is not distributed by the corporation. There is an exception to the CFC rules where the passive income is subject to a Canadian corporate tax rate exceeding 90% of the highest U.S. corporate tax rate (35% X 90% = 31.5%). When the CFC rules apply, a foreign tax credit for the Canadian corporate tax on this income is not possible, which may result in double taxation.

There may be an advantage for Americans in Canada to hold passive assets in an unlimited liability company ("ULC") largely because they avoid the double tax problems that the above-noted structures do not, and they are not considered to be either CFCs or PFICs. This type of structure is best used as a corporate holding company or to own passive assets as the typical protection under a corporation from creditors does not apply. While Canada taxes ULCs as corporations, a ULC is considered a disregarded entity for U.S. tax purposes if owned by one person or a partnership if owned by more than one person. Hence, a ULC is not subject to the potentially adverse U.S. tax consequences of being a foreign corporation. However, all income and expenses of the ULC flow through to the U.S. shareholder, eliminating the potential for tax deferral.

U.S. Foreign Trust Rules

There is widespread use of trusts in Canada for estate and tax planning purposes. These include income splitting with family members, as well as holding the growth shares of a family business or commercial real estate in an estate freeze plan.

The U.S. considers a trust to be a foreign trust if U.S. courts cannot exercise primary supervision over the administration of the trust or where U.S. persons do not have the authority to control all substantial decisions of the trust. Americans in Canada involved in these structures need to consider how U.S. tax rules that deal with foreign trusts may impact their planning. Income earned in a foreign trust that is considered to be a grantor trust, which is generally the case when the settlor and beneficiaries are Americans, is taxed directly in the hands of the grantor for U.S. tax purposes even if Canada taxes trust distributions to the beneficiaries. Income distributed from a non-grantor trust (often the U.S. classification of this trust after the settlor or transferor of the trust dies) that was earned in years prior to the year in which the income is distributed may be subject to U.S. income accumulation rules. These rules which are often referred to as the "throw-back" rules apply tax at the taxpayers U.S. marginal tax rate of (up to 39.6%) plus an interest charge on all accumulated income even if the income is from capital gains or qualified dividends.

Being mindful of these U.S. tax rules as they apply to foreign trusts can be critical in avoiding potential U.S. interest and penalty charges down the line.

U.S. Income Tax *(continued)*

U.S. Tax Filing and Reporting

There a number of U.S. tax filing requirements that Americans in Canada may need to make in addition to their annual IRS Form 1040. The most common are set out in the following table:

Common U.S. Income Tax Filing Requirements

U.S. Reporting Form	When to file	Filing Late Penalties
FinCen Report 114 *Report of Foreign Bank and Financial Accounts (FBAR)*	The aggregate value of foreign accounts such as Canadian bank or brokerage accounts, registered retirement and education savings accounts (RRSPs, RESPs), locked-in retirement accounts (LIRAs, LIFs, LRIFs and PRIFs) and Tax-Free Savings Accounts (TFSAs), which Americans own, have an indirect interest in, or have signing authority over exceeds U.S. $10,000 at any time during the year. In addition, reporting is required if an American has signature authority over a foreign financial account, but no ownership in the account.	$10,000 penalty for each account or higher civil and criminal penalties for willful failure to file.
Form 8938 *Statement of Foreign Financial Assets*	The aggregate value of "specified foreign financial assets" (i.e. foreign financial accounts, foreign securities, any interest in foreign entities, any financial instruments or contracts with a non-U.S. counter party or issuer, foreign private equity and interest in privately held foreign entities) exceeds certain thresholds. For Americans in Canada who do not file a joint tax return with their spouse, the thresholds are U.S. $200,000 at the end of the calendar year or U.S. $400,000 at any time during the calendar year. (The thresholds if filing a joint tax return with a spouse are U.S. $400,000 and U.S. $600,000 respectively).	$10,000 penalty or higher civil or criminal penalties for willful failure to file.
Form 3520 *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts* **Form 3520-A** *Information Return of Foreign Trusts with a U.S. Owner*	An American has transactions with a foreign trust or an interest in a foreign trust (e.g. Canadian family trusts, RESPs, TFSAs and other trusts formed in Canada or outside the U.S.) and/or is responsible for reporting certain transactions associated with the foreign trust. Also, when an American is in receipt of certain large gifts from certain foreign persons (e.g. a gift or bequest of more than U.S. $100,000 from a non-U.S. person or gifts of U.S. $15,358 from non-U.S. corporations or partnerships).	At least $10,000
Form 8621 *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*	An American directly or indirectly owns shares in a Passive Foreign Investment Company (PFIC) including Canadian mutual funds or other foreign securities that are classified as PFICs under U.S. tax law.	No penalty but no statute of limitation on entire return
Form 5471 *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*	An American is an officer, director or shareholder of certain foreign corporations with U.S. shareholders. For example, an American may have to file form 5471 if the person is a director or officer of a foreign corporation that has an American shareholder, is in control of a foreign corporation for an uninterrupted period of at least 30 days in a year, or is a 10% or more shareholder in a foreign corporation that is a controlled foreign corporation (CFC) for an uninterrupted period of at least 30 days in a year and that person owns that stock on the last day of the year.	$10,000 per form filed late

U.S. Income Tax *(continued)*

As indicated in the table, failure to file any of these forms can lead to significant penalties. As a result of the enactment by the U.S. of the Foreign Account Tax Compliance Act ("FATCA") the IRS will have an easier time locating non-compliant Americans in Canada. This is because financial institutions around the world are now required to report financial account information to the U.S. in relation to such persons.

U.S. Voluntary Disclosure Rules

The U.S. estimates that it loses $100 billion a year in annual tax revenues that should be paid from amongst the estimated 7 million U.S. taxpayers living abroad, 6.6% of whom are thought to properly file under U.S. tax rules.

The U.S. has implemented voluntary disclosure programs over the years, providing methods by which non-compliant U.S. taxpayers, wherever they live, can get up to date on their U.S. tax filings. One of these programs is better suited to taxpayers at a high risk of incurring significant tax penalties, and another is more suitable to those in lower risk scenarios with straight forward tax situations and minimal U.S. tax owing.

Details of these programs are beyond the scope of this paper.

U.S. Transfer Tax

U.S. transfer tax is triggered upon gratuitous transfers of property through a unified system of "gift" and "estate taxes".

Residence Defined for U.S. Transfer Tax Purposes

Exposure to the U.S. transfer tax system arises for those who are defined as "resident" for U.S. transfer tax purposes. This definition of U.S. "residence" is not the same as the definition of "residence" for U.S. income tax purposes. It covers U.S. citizens as well as those who are domiciled in the U.S., in all cases regardless of whether or not they live in the U.S. It is likely that green card holders will be considered domiciled in the U.S., especially if they have a home available in the U.S. It does not, however, cover persons whose only exposure to the U.S. is under the U.S. Substantial Presence Test, who do not intend to reside permanently in the U.S.

In this paper, a U.S. resident for transfer tax purposes may be referred to as a "U.S. Transfer Tax Resident". This definition excludes those whose only U.S. tax exposure is the ownership of U.S. situs property. The latter will be referred to as "Non U.S. Owners of U.S. Situs Assets", and are discussed below.

Scope of U.S. Transfer Tax

U.S. Transfer Tax Residents

U.S. transfer tax is triggered upon gratuitous transfers of property through a unified system of "gift" and "estate taxes", the former applicable during one's lifetime and the latter upon one's death. The system applies to every gratuitous transfer of property by a U.S. Transfer Tax Resident as gifts and inheritances are covered no matter where the property is situated in the world. The system is therefore not confined to transfers of property that is located in the U.S. – it applies to one's worldwide assets.

U.S. transfer tax (whether gift or estate tax) applies at marginal rates that begin at 18% on taxable transfers and quickly move to a top federal tax rate of 40% on transfers that exceed U.S. $1,000,000. From a practical perspective, many U.S. Transfer Tax Residents will never pay U.S. gift or estate tax as the first U.S. $5.43 million (2015 amount annually indexed) of transfers of one's personally owned wealth is exempted under a lifetime gift and estate tax exemption.

In addition to the U.S. $5.43 million lifetime gift tax exemption, there are a number of gratuitous transfers that are excluded from U.S. transfer tax. These include for 2015 (1) annual gifts of up to U.S. $14,000 to anyone other than your spouse; (2) annual gifts of up to U.S. $147,000 to your non U.S. citizen spouse; and (3) unlimited gifts to U.S. citizen spouses and charities.

One should be aware that U.S. transfer tax is extremely comprehensive, in that it even applies to gratuitous transfers that are designed to skip a generation, such as a gift under one's Will to a grandchild or transfers to a trust that can make distributions to grandchildren or lower generations. The actual tax that covers gratuitous "skipping" transfers is called the "generation skipping transfer tax" or "GSTT". It operates when the U.S. gift and estate tax would apply, and the same level of annual exclusions and lifetime exemption exists for the GSTT as does for U.S. gift and estate tax. This paper will not address GSTT in greater detail, although mention may be made of its application in certain circumstances.

It should be noted that individual U.S. states may levy additional transfer tax and may allow an additional amount to be added to the applicable federal lifetime exemption.

U.S. Transfer Tax *(continued)*

The federal U.S. lifetime gift and estate tax exemption is hereinafter referred to in this paper as the "U.S. Transfer Tax Exemption".

Non U.S. Owners of U.S. Situs Assets

Many Canadian residents own assets considered to be situated in the U.S. for U.S. transfer tax purposes, and this fact alone can create an exposure to the U.S. transfer tax system. From a practical perspective, the most common types of U.S. situs assets are real property located in the U.S., and shares of stock of U.S. companies. It should be noted that in the case of the latter, even if they are held in Canadian RRSPs, RRIFs, RESPs, RDSPs or TFSAs, or within an alter ago or joint partner trust, they will qualify as U.S. situs assets potentially exposed to U.S. estate tax.

Many Canadian residents own assets considered to be situated in the U.S. for U.S. transfer tax purposes, and this fact alone can create an exposure to the U.S. transfer tax system.

Non U.S. Owners of U.S. Situs Assets, whether living in Canada or elsewhere in the world, can be exposed to the U.S. estate and gift tax system upon the gratuitous transfer of such assets. In practice, U.S. gift tax applies only to the transfer of tangible U.S. situs property, and U.S. estate tax applies to the transfer of all U.S. situs assets. Tangible U.S. situs assets include U.S. real estate, personal property such as cars, boats, artwork, jewelry, and collectibles located in the U.S., and U.S. or foreign currency or cash within the U.S. Stock in U.S. corporations, interests in U.S. partnerships or U.S. LLCs, U.S. mutual funds, U.S. bank and U.S. brokerage accounts, fiduciary accounts in the U.S. and U.S. life insurance policies are not tangible U.S. situs assets i.e., they are considered to be intangible property, and are therefore not subject to U.S. gift tax if transferred. Non U.S. Owners of U.S. Situs Assets are not entitled to the lifetime gift tax component of the U.S. Transfer Tax Exemption, although they are able to access the annual exclusions mentioned earlier.

On the death of a Non U.S. Owner of U.S. Situs Assets, the U.S. Transfer Tax Exemption is available, but is limited to U.S. $60,000. However, due to the Canada-U.S. tax treaty, Canadian residents are entitled to an enhanced exemption, which is essentially a fraction of the U.S. Transfer Tax Exemption (i.e. the U.S. Transfer Tax Exemption is multiplied by a prorated amount calculated by taking the value of one's U.S. situs assets and dividing it by the value of that person's worldwide estate). In essence, U.S. estate tax will not apply to Canadian Non U.S. Owner of U.S. Situs Assets who dies in 2015 if the value of their U.S. situs assets is not more than U.S. $60,000 or the value of their worldwide estate does not exceed U.S. $5.43 million. Under the treaty, a foreign tax credit may be claimed by non U.S. Owners of U.S. Situs Assets on their Canadian income tax return for U.S. estate tax paid on U.S. situs assets. The tax treaty also allows Canadians a "marital credit" that in effect is worth the value of their prorated exemption. This means a Canadian couple will typically be able to transfer U.S. situs assets to each other valued at twice the amount of their prorated exemption. However, upon the death of the surviving spouse, the amount of the U.S. Transfer Tax Exemption will be only the latter's prorated amount. Refer to the example for U.S. estate tax for Canadians.

Example of U.S. Estate Tax for Canadians

A Canadian that dies in 2015 owning a U.S. condominium valued at U.S. $750,000 (and no other U.S. situs property) and whose net worth is U.S. $7,500,000 will be able to access 10% of the applicable U.S. Transfer Tax Exemption i.e., U.S. $543,000. Since their U.S. situs property is worth U.S. $750,000 there remains exposure on U.S. $207,000 which results in a U.S. estate tax liability of U.S. $36,520. Without the prorated exemption i.e., with only the basic U.S. $60,000 exemption, their exposure to U.S. estate tax would have been on U.S. $690,000 resulting in an estate tax of U.S. $235,300. The difference of almost U.S. $200,000 illustrates the value of the enhanced exemption available when the prorated exemption is applied. If the assets are transferred to a Canadian spouse, the marital credit would provide an additional exemption of approximately U.S. $543,000 that would be large enough to eliminate U.S. estate tax on the death of the first spouse. Upon the death of the surviving spouse a U.S. estate tax liability of U.S. $36,520 will result. If there is an accrued gain on the property, a foreign tax credit may be claimed for the U.S. estate tax to reduce the Canadian income tax.

Additional planning will be discussed later in the section called "Planning for Non U.S. Owners of U.S. Situs Assets" that may be useful in minimizing exposure to U.S. transfer tax.

U.S. Transfer Tax *(continued)*

Planning for U.S. Transfer Tax Residents Living in Canada

As the exposure to the U.S. transfer tax system applies to U.S. Transfer Tax Residents wherever they live, those living in Canada need to plan in pretty much the same way as U.S. citizens and green card holders that live in the U.S. i.e., as if they themselves are living in the U.S. For ease of reference, we will hereinafter refer in this part only to U.S. citizens or non U.S. citizens, and not to green card holders (although the latter are considered to be U.S. Transfer Tax Residents). All references in this part to U.S. Transfer Tax Residents are to those who live in Canada and are therefore also residents of Canada for tax purposes.

Such persons find themselves in a myriad of possible family, and therefore, planning, situations. For example, some will be married to U.S. citizens, while others are married to non U.S. citizens. In some cases their children will be U.S. citizens, and some not.

The key planning objectives to mitigate the impact of U.S. transfer tax for U.S. Transfer Tax Residents living in Canada are:

(1) to ensure that the full amount of the U.S. Transfer Tax Exemption available to a U.S. Transfer Tax Resident is ultimately utilized

(2) where upon death one's net worth exceeds the current value of the exemption available i.e., in 2015, U.S. $5.43 million, to employ tax deferral techniques where one spouse survives the other

(3) to use gifting techniques to:

   a. make use of all available exclusions as well as the U.S. Transfer Tax Exemption

   b. reduce your taxable estate that will be exposed to U.S. transfer tax

   c. shelter the maximum amount of one's assets that are expected to increase over time from exposure to U.S. transfer tax

Planning for U.S. Tax Transfer Residents – Both are U.S. Citizens

Portability

In smaller estate situations, and where assets are not expected to grow, the portability provisions are a simple method to ensure that each spouse's U.S. Transfer Tax Exemption is fully utilized. Through an election on the U.S. estate tax return of the first spouse to die, these rules permit that spouse's unused U.S. Transfer Tax Exemption to be transferred to the surviving spouse. These provisions are available between U.S. citizen spouses, and cannot be used to make gratuitous transfers to which GSTT would apply.

Since the portability provisions do not insulate the future growth of assets from U.S. transfer tax, this type of planning is basically a last resort where other more effective planning strategies have not been employed.

Tax Deferral Planning

Where one spouse outlives the other, the ability to delay the imposition of U.S. transfer tax until the death of the survivor can be extremely useful. In the case of U.S. citizen spouses wherever they live, a "marital deduction" provides an unlimited U.S. transfer tax deferral opportunity available to them for both lifetime gifts and bequests made upon death. Not only is the tax payable at a later date, but the surviving spouse is not forced to sell assets to pay the tax in the event of a family situation without ample liquidity to satisfy the tax burden that arises on the death of the first spouse. With the portability provisions the surviving spouse has the potential to transfer up to U.S.$10.86 million of wealth free of U.S. estate tax to intended beneficiaries (i.e. using the maximum of U.S.$5.43 million of their predeceased spouse's unused U.S. Transfer Tax Exemption and another U.S.$5.43 million of their own).

Annual Exclusions and Reducing Your U.S. Taxable Estate

When U.S. estate tax exposure exists, certain transfers may be made during your lifetime to reduce your taxable estate, not only at the time they are made, but in respect of any related growth that would have arisen in the future. The cumulative effect over time is often more than one would think.

U.S. Transfer Tax *(continued)*

These transfers do not use up your lifetime U.S. Transfer Tax Exemption as they are made free of U.S. gift tax. They include: (1) annual gifts of U.S. $14,000 that can be made to an unlimited number of people and (2) unlimited direct payments on behalf of family members for select health care and education related expenses.

Charitable Giving

Gifts made to charities registered in either Canada or the U.S., whether made during one's life or under your Will, do not attract U.S. gift tax, and will reduce the value of your U.S. taxable estate.

Credit Shelter Trust

If you expect the value of your surviving spouse's estate will exceed U.S. $10.86 million, you should consider a Credit Shelter Trust ("CST") strategy in your estate planning.

Assets in a CST that are transferred when the first spouse dies will be protected (including any future growth of those assets) from U.S. estate tax when the second spouse dies. Upon the death of the first spouse, an amount equal to that spouse's unused U.S. Transfer Tax Exemption is transferred free of estate tax to the CST for the benefit of the second spouse. The balance of the assets in the estate may be transferred to your surviving spouse directly or to a spousal trust using the unlimited marital deduction.

The beneficiaries of the CST are usually your surviving spouse and may include your children. Your spouse (and should you wish, your children) may receive the annual income of the CST, and access to the capital would typically be for health, education, support and maintenance needs i.e., these reasons to access trust capital are referred to as "ascertainable standards".

In order to ensure that the future growth of the trust assets is not taxed on the death of any of the beneficiaries, no beneficiary should have a general power of appointment. A general power of appointment is a power exercisable in favour of the holder, the holder's estate, and creditors of the holder's estate. If any beneficiary has the ability to withdraw funds from the trust, then such funds generally will be subject to U.S. estate tax at the beneficiary's death, even if the power was not exercised. A beneficiary can have a limited power of appointment, such as the ability to withdraw funds for an ascertainable standard. However, if the trust has an independent trustee, then the independent trustee discretion can be exercised without being limited to ascertainable standards.

Upon the death of the second spouse assets may remain in the CST for the benefit of your children and where your children are U.S. citizens, wherever they live, the continuing protection from U.S. transfer tax gained through the CST will be welcome. It can be advantageous for the balance of the assets not transferred to the CST to fund a second testamentary spousal trust rather than going directly to the surviving spouse. The surviving spouse must be paid the annual income of the spousal trust, and must be the only beneficiary that can access to the capital during her lifetime. While there continues to be U.S. estate tax exposure that will be payable on the testamentary spousal trust's assets upon the death of the second spouse, the trust offers other benefits including asset protection, probate avoidance, and ensures that one's chosen heirs eventually benefit from the assets held in the trust.

Let's consider an example where the CST and marital deduction strategies are employed. Assume that a 50 year old U.S. Transfer Tax Resident has a net worth of U.S. $5.43 million. She expects that over time, her net worth will grow and by the time she dies it will be worth U.S. $10.86 million. Upon her death, the first U.S. $5.43 million is transferred to the CST and the balance of U.S. $5.43 million is transferred to a testamentary spousal trust. The value of these assets is expected to grow before the death of the second spouse. When the second spouse dies the assets in the CST (including any growth) are protected. Only the assets in the spousal trust (including any growth) and the value of assets owned personally are subject to U.S. estate tax should they exceed his U.S. Transfer Tax Exemption of U.S. $5.43 million.

For families whose net worth exceeds the collective value of the personal U.S. Transfer Tax Exemptions of each spouse, using only the CST and marital deduction will result in some degree of U.S. transfer tax liability before the estate reaches the next generation.

U.S. Transfer Tax *(continued)*

Advanced Gifting Techniques – U.S. Transfer Tax Planning Implemented During Your Lifetime

What if instead of relying solely upon the CST supported by the marital deduction, the first spouse settles and funds an estate protected trust during her lifetime?

For ease of reference, we will call these lifetime funded trusts "Dynasty Trusts". These types of trusts are intended to protect a family's net worth from U.S. transfer tax for more than one generation. The key aspect to such trusts is their long term nature; CSTs intended to last beyond the passing of the second spouse would meet this definition.

Continuing with our previous example, the 50 year old spouse, funds a Dynasty Trust with her net worth of U.S. $5.43 million. Transferring any amount up to her U.S. Transfer Tax Exemption can be accomplished free of U.S. gift tax, and these assets and all future growth thereon will thereafter be protected from U.S. transfer tax. In our example, the future growth of these assets reached U.S. $10.86 million, in effect, double the amount that could have been protected under her current U.S. Transfer Tax Exemption.

By employing this strategy, at the time this spouse dies there will be no need for a CST or use of the marital deduction, because all of her assets i.e., in our example, initially U.S. $5.43 million, will be held in the trust she created at age 50. The limitations upon the death of this spouse on the amount of assets, and their growth, that could be protected within a CST, and the inability to protect the growth of the assets transferred using the marital deduction, will no longer matter since these mechanisms will not be needed at that time.

Even better, protection from U.S. transfer tax is achieved on the continuing growth of all of the assets transferred to and held in the trust until the death of the surviving spouse, and in many cases beyond this time if the trust continues to operate for the benefit of their children. In our example, the full U.S. $10.86 million at the time of the death of this spouse will be insulated from U.S. estate tax thereby leaving a larger estate to the surviving spouse, if the spouse that created the trust dies first, and if this spouse dies second, to their heirs.

The above example illustrates the potential wealth enhancing benefit of engaging in U.S. transfer tax planning during one's lifetime rather than waiting until death. In effect, we are looking at a timing issue: if you have the means, should you fund a trust before death, and arguably as soon as possible, or not?

The benefits of Dynasty Trusts extend beyond protection from U.S. transfer tax, including asset protection, avoidance of probate and certainty that one's estate will wind up with those you intend it to.

Dynasty Trusts

It is rarely recommended to allocate all of your assets to any particular planning idea or solution, and we are not suggesting that here. In considering then, how much of one's net worth to deploy to this strategy, the first question should be whether the owner of the assets will continue to have access to them after they are transferred to the Dynasty Trust. It may be possible for the first spouse to be one of the discretionary beneficiaries of the Dynasty trust that she settled and funded provided the trust is set up properly. This requires very specific professional tax advice, a discussion of which is beyond the scope of this paper.

In light of the need to balance between the notion of beneficial rights and interests, it is preferable that the first spouse retain sufficient assets outside of the Dynasty Trust, in her own name, to maintain her lifestyle for the long term. These personally owned assets can of course be dealt with, however this spouse wishes, leaving the assets in the Dynasty Trust as primarily destined for other family members.

In our example, the first spouse is in a good position, since whatever amount she decides to deploy to the Dynasty Trust will fall below her U.S. Transfer tax Exemption. In situations where her net worth exceeds her U.S. Transfer Tax Exemption, she will be able to contribute an amount up to her exemption on a tax free basis, and if the trust is structured properly, she can make tax free gifts annually to the trust up to the annual exclusion amount, currently U.S. $14,000.

The benefits of Dynasty Trusts extend beyond protection from U.S. transfer tax, including asset protection, avoidance of probate and certainty that one's estate will wind up with those you intend it to. Where the planning is done during one's lifetime, these benefits apply not only to the surviving spouse upon his death, but to the living settlor of the trust as well.

Dynasty Trusts are not intended to provide any Canadian or U.S. income tax advantages, but they are impacted by both U.S. and Canadian income tax rules. For U.S. Transfer Tax Residents they are typically structured as resident in Canada or dual-resident (Canadian and U.S.) trusts. They may be considered to be "grantor trusts" for U.S. income tax purposes depending upon the terms of the trust. But at the time that the grantor dies, under U.S. rules, the trust then automatically becomes a non grantor trust. As a resident of Canada, the trust will be subject to the Canadian "21 year deemed disposition rules". This means that every 21 years from the creation of the Dynasty Trust,

U.S. Transfer Tax *(continued)*

the trust will be deemed to have disposed of all of its assets at their then fair market value. In cases where there are unrealized capital gains on assets held in the trust, a decision will need to be made about whether to (1) pay the tax at the 21st year, in effect paying the tax "in advance" and correspondingly increasing the cost base to the trust of its assets, or (2) distribute the trust assets to one or more of its Canadian resident beneficiaries at its cost base, in effect avoiding the deemed disposition.

The difficulty with this decision is that choosing to avoid Canadian capital gains tax means effectively ending the operation of the trust, and therefore possibly undoing the original intent of the planning which was to avoid the application of U.S. transfer tax on these assets. This will be the case if one or more U.S. Transfer Tax Residents are the persons to whom the assets are distributed.

In such cases, it is suggested that the trust assets be invested so that either (1) capital gains are routinely recognized on an ongoing basis, thereby rendering the 21 year rule far less of a concern as it approaches, or (2) there is an expectation from the outset that if there are no alternatives to distributing the trust assets to one or more U.S. Transfer Tax Residents just before the end of the 20th year of the trust i.e., this is where having a "Canadian only" tax resident could be helpful, the trust will in fact pay any Canadian capital gains tax triggered at that time.

The complexities that arise in relation to Dynasty Trusts from an income tax perspective mean that it is very important to seek the advice of cross border tax and/or legal professionals.

Life Insurance

There are a few key planning points that U.S. Transfer Tax Residents that hold or are thinking of investing through a life policy should consider.

With proper planning you can ensure that the ultimate amount paid out to your heirs from the policy, typically referred to as the death benefit (which would invariably be significantly higher than the amounts invested), will not form part of your U.S. taxable estate.

The key planning is that the U.S. Transfer Tax Resident may not own or control the life policy. The policy is therefore best held in i.e., owned by, a trust, often referred to as an Irrevocable Life Insurance Trust, or an ILIT. The ILIT should also be the beneficiary of the policy. The insured should not be a trustee or beneficiary of the ILIT, and should not have "incidents of ownership", which means they cannot be able to name or change the beneficiaries, borrow against the policy, access the cash value, or cancel the policy.

Funds transferred to the ILIT are generally subject to U.S. gift tax, even if the ILIT uses them to invest in life insurance. The insured therefore can make use of his U.S. Transfer Tax Exemption, but before doing so, can make annual gifts of up to U.S. $14,000 per each beneficiary of the ILIT, if the trust is structured properly. So if the insured has a spouse and four children, up to U.S. $70,000 per year can be gifted to the ILIT before gift tax becomes a concern.

Investing through life insurance owned by an ILIT is therefore a very attractive way of not only reducing one's U.S. taxable estate by making tax protected gifts to the trust to fund the policy, but of creating additional value for your family or charitable purposes that will not form part of your U.S. taxable estate.

Planning for U.S. Transfer Tax Residents – Only One is a U.S. Citizen

Most of the planning ideas that will be discussed below, where one spouse is a U.S. citizen i.e., a U.S. Transfer Tax Resident, and the other is neither a U.S. citizen nor a U.S. domiciliary, are similar to those just covered where two U.S. citizens are living in Canada. In some cases the variation in the planning opportunities depends upon who is the surviving spouse. As a reminder, the portability provisions discussed earlier only apply where both spouses are U.S. citizens or residents of the U.S. for estate tax purposes, and therefore are not applicable in this section.

Annual Exclusions and Reducing Your U.S. Taxable Estate

When the transferor is a U.S. citizen living in Canada, along with the planning benefits reviewed earlier in respect of annual gifts of up to U.S. $14,000 made to any number of people, there is an additional planning advantage in making gifts to one's Canadian non U.S. citizen spouse. U.S. transfer tax rules permit an annual gift of

U.S. Transfer Tax *(continued)*

U.S. $147,000 to such spouses, which not only reduces the transferor's U.S. taxable estate, but provided that the gifts are of non U.S. situs assets, removes these assets, and any future growth thereon, completely from the U.S. transfer tax system.

When the transferor is a non U.S. citizen living in Canada married to a U.S. citizen, three key points will influence any planning to reduce this person's U.S. taxable estate i.e., comprised of their U.S. situs assets. First, any assets, whether U.S. situs or not, gifted by a non U.S. citizen spouse to a U.S. citizen spouse, whether during life or upon the former's death, will increase the latter's U.S. taxable estate, and may take it above (or eventually exceed) that person's U.S. Transfer Tax Exemption unless the gift will be used to pay for expenses. The second key point is that since the transferor's exposure to U.S. transfer tax is only in relation to U.S. situs assets, it may make sense to gift U.S. situs assets. Third and finally, U.S. gift tax does not generally apply to non U.S. citizens unless they gift tangible property located in the U.S. In such cases, the annual exclusion rules can avoid the imposition of U.S. gift tax and allow the non U.S. citizen to reduce his U.S. taxable estate.

Charitable Giving

The use of charitable gifting to reduce one's U.S. taxable estate is more beneficial to U.S. citizens living in Canada, as non U.S. citizen spouses will only benefit in this manner if they make charitable gifts of U.S. situs property. Other property owned by them is not subject to U.S. transfer tax.

Life Insurance

U.S. Transfer Tax Residents will benefit from U.S. transfer tax protection where assets are invested in life insurance for the reasons discussed earlier. Therefore a U.S. citizen spouse can make use of this planning, even though her spouse and children may not be U.S. Transfer Tax Residents. In these cases, there may be less reason to maintain the insurance proceeds in the ILIT after the demise of the U.S. citizen spouse, unless there is still a need for protection against U.S. transfer tax for the spouse and children.

> The marital credit (which is available under the Canada U.S. tax treaty) actually eliminates the estate tax rather than deferring it.

U.S. Citizen Spouse Living in Canada Predeceases Her Canadian Non U.S. Citizen Spouse

A U.S. citizen spouse who predeceases her non U.S. citizen spouse has two U.S. transfer tax planning choices for assets in excess of their U.S. Transfer Tax Exemption. The first involves a tax deferral with the use of the unlimited marital deduction and requires the use of a special form of U.S. trust called a qualified domestic trust or a "QDOT", and the second involves a tax credit called the "marital credit" that is available specifically under the Canada U.S. tax treaty. A key point to be aware of is that only one of these strategies can be chosen, and once this choice is made, it cannot be reversed.

The U.S. unlimited marital deduction resulting in U.S. estate tax deferral is available when a U.S. citizen spouse dies before her non U.S. citizen spouse and the deceased's assets are transferred to a QDOT. U.S. transfer tax will then only be payable upon the death of the surviving spouse, or at such earlier time as capital distributions are made from the trust. At this time, the capital paid out during his lifetime or the assets in the trust upon his death will be treated as part of the estate of the first spouse to die, and U.S. estate tax will be due if these assets exceed the first spouse's U.S. Transfer Tax Exemption.

The marital credit (which is available under the Canada-U.S. tax treaty) actually eliminates the estate tax rather than deferring it, so under certain circumstances, it can be more effective than simply delaying the eventual payment of U.S. estate tax.

The marital credit may be claimed in addition to the deceased's U.S. Transfer Tax Exemption, and its value is the amount of the estate tax owing up to the deceased's U.S. Transfer Tax Exemption. If the deceased's U.S. Transfer Tax Exemption is the maximum available i.e., U.S. $5.43 million, then the marital credit may almost be equal to this amount, thereby providing estate tax protection against just under double that value.

Since only one of these strategies can be chosen, how does one choose between these two U.S. transfer tax planning options? While there is no one right answer, if the assets of the deceased do not exceed approximately twice the value of her U.S. Transfer Tax Exemption i.e., up to U.S. $10.72 million, the marital credit will potentially eliminate the tax owing and would therefore be the better choice. This assumes the deceased intends to transfer all assets to the surviving spouse.

It may also be the better choice if her assets exceed U.S. $10.72 million, but the question then is by how much? That is not an easy question to answer, as a cost benefit analysis is needed to compare the value of the deferral on the potential future value of an estate where the actual tax owing upon death could have been eliminated, and U.S. estate tax eventually paid on the excess of the estate beyond the deceased's U.S. Transfer Tax Exemption.

There may be no specific need for the

U.S. Transfer Tax *(continued)*

planning to avoid having the deceased's assets, and the growth thereon, from being included in the U.S. taxable estate of family members, unless one or more of them is a U.S. Transfer Tax Resident and estate tax exposure is an issue. Where planning is warranted the use of a properly structured CST or Dynasty Trust discussed earlier may be implemented to protect the assets and future growth from U.S. estate tax when one or more of the beneficiaries die. While the planning concepts are essentially the same as already discussed, one important point to consider when a non U.S. citizen spouse is included as a beneficiary of these trusts is that the use of the unlimited marital deduction or marital credit will not be available for assets transferred to these trusts. Therefore, typically, the first U.S. $5.43 million is transferred to these trusts free of U.S. estate tax using the deceased U.S. citizen's U.S. Transfer Tax Exemption. If the balance of the assets is not greater than U.S. $5.29 million they may be transferred free of U.S. estate tax to the surviving spouse directly or to a separate spousal trust (that is not a U.S. estate tax protected trust) using the marital credit. Alternatively, where the balance of the assets exceeds U.S. $5.29 million and the marital credit is not sufficient to offset the U.S. estate tax, the assets may be transferred to a QDOT and U.S. estate tax is deferred using the unlimited marital deduction.

U.S. Citizen Spouse Living in Canada Outlives Her Canadian Non U.S. Citizen Spouse

Where the Canadian spouse dies first, his personal exposure to U.S. estate tax will be only in relation to his U.S. situs assets and the unlimited marital deduction may be used to defer U.S. estate tax in the same manner as is available between two U.S. citizen spouses living in Canada, discussed earlier.

However, we may not want to increase the U.S. taxable estate of a U.S. Transfer Tax Resident, especially where there is the likelihood that the latter will eventually own assets in excess of his U.S. Transfer Tax Exemption. Here, the use of a properly structured trust to protect assets from U.S. estate tax is recommended.

We have discussed the use of these trusts in the earlier sections covering CSTs and Dynasty Trusts, and the planning concepts are essentially the same, so we need not repeat them here. However, one important point to consider is that when U.S. situs assets are transferred to such trusts the unlimited marital deduction is not available, therefore to avoid U.S. estate tax on the death of the non U.S. citizen spouse who dies first, the U.S. situs assets should be transferred to the surviving U.S. citizen spouse directly or to a spousal trust not structured as a U.S. estate tax protected trust.

> If you expect to someday sell your "U.S. situs property" but unfortunately die owning it, then instead of U.S. capital gains tax, your estate may be exposed to U.S. estate tax.

Planning for Non U.S. Owners of U.S. Situs Assets

This section looks at planning for Non U.S. Owners of U.S. Situs Assets focusing in part on planning to reduce or eliminate exposure to U.S. transfer tax with strategies implemented at the time the property is purchased.

The planning available to reduce or eliminate the U.S. transfer tax payable upon the transfer of U.S. situs assets ranges from simple to complex. As such, your choice of planning may well be influenced by the extent of your exposure to U.S. transfer tax. Where your exposure is significant, you may want to structure how to hold your U.S. situs assets so that upon death your exposure is minimized. Where the exposure is less significant, simpler planning can be undertaken, including using life insurance to pay your liability.

The most likely U.S. situs assets that a Canadian resident will own are U.S. stocks and U.S. real estate for personal use (the latter hereinafter in this section referred to as "real estate"), so we will concentrate on planning considerations for these two types of property. For ease of reference these types of property may together be referred to in this section as "U.S. situs assets". Real property in the U.S. purchased for commercial purposes involves different planning considerations, some of the income tax issues of which were touched upon in the section called "Canadians Owning and Renting U.S. Real Property". We will briefly discuss options for owning U.S. commercial real property later in this section.

Initial Considerations

The first things to consider when purchasing "U.S. situs assets" are (1) the cost, (2) whether you are purchasing with a long term hold in mind, and (3) your current and projected U.S. dollar net worth.

If you expect to sell the property, then provided you do not die before doing so, you may be faced with U.S., and possibly, Canadian, capital gains tax. U.S. capital gains tax in these circumstances was discussed in the section "Canadians Owning and Renting U.S. Real Property", and would apply in the case of the sale of U.S. real property, but generally not to U.S. stocks.

If you expect to someday sell your "U.S. situs property" but unfortunately die owning it, then instead of U.S. capital gains tax, your estate may be exposed to U.S. estate tax. If you decide to gift rather than sell it, then you will need to address U.S. gift tax. Although we have already discussed these

U.S. Transfer Tax *(continued)*

possible scenarios, it is important to know your intentions, and in most cases, to plan for unexpected circumstances. This means planning to address U.S. Transfer Tax in any event.

As noted earlier, as a Canadian resident who is not a U.S. Transfer Tax Resident, if your U.S. dollar net worth is less than the prevailing U.S. Estate Tax Exemption at the time of your death, then you will not have a U.S. estate tax liability. In that case, no U.S. transfer tax planning is necessary, but if you own U.S. real property, you should consider updating your Wills and looking into U.S. probate planning options to hopefully set up an easy eventual transfer of the property to your heirs.

If your current or projected U.S. dollar net worth is or may exceed your U.S. Estate Tax Exemption, then you may have an eventual U.S. transfer tax exposure. In this situation, the cost of your U.S. situs property, and its expected appreciation over time, combined with the length of time you plan to own the property, allows you to estimate varying levels of exposure to U.S. transfer tax at different points of time. Usually an estimate is done of the immediate exposure if you die tomorrow, as well as the eventual exposure if you die a fair time down the road.

The reason all of these factors are important is that they should influence whether you undertake simpler or more complex planning. If your current exposure to U.S. transfer tax is manageable, and you are not expecting a significant increase in the value of the property, then you may not do any planning specifically to minimize U.S. transfer tax. If your exposure is or will become less manageable or enough that it will create a liquidity problem for your estate, or you simply do not want your estate to be faced with this liability, then planning to avoid U.S. transfer tax is recommended.

One other important point to keep in mind is that planning to avoid U.S. transfer tax is invariably much easier to design and implement if it is done at the time that the U.S. situs asset is being purchased. If it is approached after the asset is already owned by you, or a legal structure you are connected with, then you may need to contend with U.S. gift tax should you wish to change the way that the property is owned. In many cases this will be hard to achieve, and a sale of the property, or the purchase of life insurance, may be the most practical ways to deal with the issue.

Personal Ownership

If you are considering the purchase of either U.S. stocks or real estate, the first question often is how to take title, and the simplest answer is in your own name, or jointly with your spouse with a right of survivorship ("JTWROS"). In the case of U.S. real estate in particular, the latter avoids the need for the property to pass through your estate and ultimately the local state probate rules upon the first death.

Unfortunately, owning the property JTWROS often does not work well from a U.S. estate tax perspective. Upon the death of the first spouse, unless it can be clearly shown that the surviving spouse, with her own funds, either purchased the property in its entirety, or contributed to the purchase of the property, U.S. tax rules assume that the spouse that died was the person who owns the property or estate tax purposes. The result is that the full U.S. estate tax liability, if any, will be payable at that time.

This means that not only must cash be allocated to the payment of U.S. estate tax at a time when the second spouse is still alive and may need the funds or only have access to illiquid assets, but upon the death of the surviving spouse, if the property is still owned by her, U.S. estate tax will again be payable, this time on the value of the property at that time. In effect, U.S. estate tax will be paid twice on the same property, once at the time that each spouse dies.

There is a bit of relief as the surviving spouse is entitled to a credit for part of the U.S. estate tax paid on the death of the first spouse, but this credit reduces quickly on a sliding scale starting two years after the first spouse dies with no credit after 10 years.

Also, since owning the property JTWROS leads to the surviving spouse eventually owning the property, probate will be required upon her death if she still owns the property, which means that the costs and delays associated with probate will someday be experienced by your heirs.

U.S. Transfer Tax *(continued)*

Purchasing the property in the name of one spouse leads to almost the exact same disadvantages, including the need to go through the probate system twice, so this is rarely seen as a better solution on its own. If a testamentary trust is used to exclude U.S. situs assets from passing to the survivor's estate, that may be better planning. Another alternative is to use a QDOT to defer the payment of estate tax upon the death of the first spouse, but this only works until the second spouse dies.

If personal ownership is desired, many planners recommend taking title as tenants in common. In this case, both spouses are considered to own an undivided equal or unequal interest in the property, and this interest passes through the Will of each spouse. The result is that only the deceased's interest will be subject to U.S. estate tax, thereby avoiding the possibility that the full value of the property will be exposed to U.S. estate tax upon the death of the first spouse. In addition, since holding a divided interest in the property is less marketable than a sole interest, each co-owner may apply a valuation discount when determining the fair market value of their respective share of the property for U.S. estate tax purposes, which will decrease the value of the U.S. taxable estate.

To avoid estate tax arising on the full value of the property of the second spouse to die, the same planning just mentioned involving a testamentary trust or a QDOT may be utilized. However, be wary of owning property as tenants in common with children, or with spouses in marriages that are not stable, as each co-tenant is able to sell or gift his share of the property, or place a mortgage on it, without the consent of the other co-tenant. Also, taking title to the property as tenants in common does not shelter the property from probate, unless a portion is transferred into a "revocable trust". However, a revocable trust does not protect from U.S. estate tax, it is primarily used to avoid state probate.

The common types of legal structures that may be used to manage your exposure to U.S. transfer tax upon your death include Canadian trusts, corporations and partnerships.

Non-Recourse Mortgage

Where personal ownership of U.S. real estate is desired, a simple strategy to reduce the value of the property is to place a non recourse mortgage against it. A non recourse mortgage may only be realized by the lender upon default against the property, and not the borrower. In this case, the full value of the mortgage may be deducted from the value of the property for U.S. estate tax purposes. The funds borrowed may be invested to earn income, thereby creating a revenue flow and tax deductible interest.

Ownership Through A Legal Structure

When the value of the U.S. situs assets you plan to acquire is such that a U.S. transfer tax liability will be created either immediately or over time, you may wish to structure your ownership of the U.S. situs assets such that the assets are not in your, and possibly your spouse's, personal names.

When you structure the ownership of U.S. situs assets through some type of Canadian legal structure, the property that you will own upon death will not be the U.S. situs asset itself, but an interest in a Canadian legal structure that in turn owns the U.S. situs assets and the hope is that the U.S. transfer tax rules will not apply. Some refer to this as indirect ownership of the asset around which you are trying to plan.

Transferring U.S. situs assets into a Canadian legal structure after you already own them, may subject you to U.S. gift tax, if the assets are tangible U.S. assets such as U.S. real estate. The good news is that where the U.S. situs asset is U.S. stocks (intangible assets), there is no gift tax upon a lifetime transfer. It must be noted that under Canadian tax rules, any transfer of property may result in a disposition that can trigger tax on accrued gains.

The common types of legal structures that may be used to manage your exposure to U.S. transfer tax upon your death include Canadian trusts, corporations and partnerships.

Trusts

While a Canadian trust may be used to own any kind of U.S. situs asset they are often used to own U.S. real estate. If you settle and fund a trust used to purchase U.S. situs assets and the trust is structured such that it is irrevocable and no beneficiary has a general power of appointment, then the assets it owns will not form part of your or any of the beneficiaries' U.S. taxable estates upon death.

Generally a trust to hold U.S. real property is established by one spouse for the benefit of the other spouse, where the beneficiary spouse has the right to use the property during her lifetime. Although the spouse who contributes the assets to the trust should have no retained life interest, the beneficiary spouse can allow her spouse to use the property. If the trust has an independent trustee, the trustee can be provided with wide discretion to distribute trust capital to the beneficiaries should this be desired.

Since the U.S. situs assets will not pass through your estate, U.S. probate is also minimized.

There are some disadvantages of using a trust to hold U.S. property. If the trust is resident in Canada (which it would be if a Canadian resident contributed to the trust),

U.S. Transfer Tax *(continued)*

the assets in the trust will incur a deemed disposition on the 21st anniversary of the establishment of the trust resulting in the Canadian taxation of any appreciation of assets held in the trust. The deemed disposition can be avoided if the property is distributed to a Canadian resident prior to this date, but this could expose the beneficiary to U.S. estate tax. Another disadvantage occurs if the beneficiary spouse predeceases the contributing spouse. Since the contributing spouse cannot have any retained life interest in the trust assets, that spouse must now rent the property at fair market value, if he wished to use the property, since his deceased spouse is no longer available to provide him access to the property.

For U.S. situs assets such as shares of U.S. companies, a better way to hold them is through a non-U.S. corporation.

Corporations

While a Canadian corporation may be an ideal way to hold U.S. stocks it may not be an appropriate structure to own U.S. real estate. When you own U.S. stocks through a Canadian corporation the U.S. transfer tax rules do not deem the U.S. stocks to be owned by you directly. The rules would find that you own stock of a non U.S. corporation and therefore upon your death there is no U.S. estate tax as you do not own a U.S. situs asset.

U.S. real estate is a more complicated asset to own through a corporation. If U.S. real estate is held for personal use, the U.S. rules may look through the corporate structure, and consider the real estate to be your own, and Canadian rules may impose annual income tax upon in relation to the benefit you enjoy by living in a corporate owned asset. While this is not an issue if the U.S. real estate is held for commercial use, there are other disadvantages to consider. First, U.S. tax rates on capital gains within corporations are typically higher than the rates on personally owned property. Second, due to the application of both Canadian and U.S. tax rules, higher taxation can result and therefore must be reviewed. However, these downsides must be compared to the upsides just described, which can make it preferable to a trust as you maintain full control over the shares of your corporation.

Partnerships

Some professional advisors suggest the use of partnerships to own U.S. situs assets. You can avoid the higher taxation through corporate ownership, discussed earlier, that may result from owning U.S. real estate rental property and with proper planning it may be possible to minimize U.S. transfer tax on your death. Partnership interests also need to be dealt with under your Will, and there are some important tax elections to be made within 75 days of your death, failing which, the planning could be ineffective.

Overall, partnership planning entails a number of additional planning issues and complexities that are beyond the scope of this paper, and therefore will not be dealt with herein.

Be Wary of U.S. Limited Liability Companies

U.S. limited liability companies ("LLCs") are often used in planning for U.S. taxpayers, combining the benefits of corporate limited liability protection with flow through taxation to its members.

Unfortunately Canada does not tax U.S. LLCs on a flow through basis to their members. Canada taxes LLCs as corporations, creating a myriad of tax complexities and mismatches when a Canadian tax resident is a member of a LLC.

It is therefore highly recommended that anyone resident in Canada, including U.S. Income Tax Residents and U.S. Transfer Tax Residents, avoid holding U.S. assets of any kind within a U.S. LLC.

Leaving the U.S. Tax System

Over the years, the U.S. has had a number of regimes that govern how one can exit the U.S. tax system. These regimes involve the renunciation of U.S. citizenship or green cards, as applicable.

Under the most recent regime enacted in 2008, it is possible that an exit tax will be payable if one is considered to be a "covered expatriate". A covered expatriate would be any U.S. citizen, and any green card holder who has held the green card for at least 8 of the past 15 years, if they pass any of the following three tests:

- their average annual net income tax in the U.S. was more than $160,000 in the previous five years
- their net worth is at least U.S. $2 million
- U.S. tax returns have not been filed over the previous five years

In the event that they meet any of these tests, if they choose to expatriate, then they will be deemed to have sold their assets at that time and any capital gains in excess of U.S. $690,000 (the current exemption for covered expatriates) will be taxed at current capital gains tax rates.

If you do not meet any of these tests, then you will not be a covered expatriate, and you can renounce your citizenship or relinquish your green card, and from that time, exit the U.S. tax system.

There is an exception for those who meet the above tests if you are a dual citizen at birth and live in the other country i.e., not the U.S., or you have not lived in the U.S. for more than 10 years and have not yet reached 18 ½ years old.

If you are a covered expatriate, there are rules that cover most of the other assets you own, retirement plans that you are part of, or interests in trusts or other legal structures, all of which should be addressed but are beyond the scope of this paper.

One caveat to be aware of is that a covered expatriate who gifts assets either during life or upon death, to a U.S. citizen or green card holder, will subject the latter to U.S. gift tax upon receipt of the gift at a flat tax rate of

40%. This means that before deciding to exit the U.S. tax system, if you will be a covered expatriate, then you need to consider the tax status of your heirs and factor this into your overall estate and tax planning.

For those who meet the above tests, with proper planning, the use of many of the strategies discussed in this paper to reduce your net worth may be used to ensure you can expatriate without falling into the classification of covered expatriate.

Your RBC advisor's role

RBC works with clients and their independent legal or tax advisors to help achieve objectives and maximize overall wealth. Our specialized financial advice includes estate planning solutions, succession planning from a business and personal perspective, borrowing and credit, cash management, wealth management, investment management, financial planning, personal retirement planning, trustee service, philanthropy and insurance. Please contact your RBC advisor for more information or visit http://www.rbcwealthmanagement.com/canada.html for an introduction to an RBC advisor.

Where to Start

The U.S. tax system and the tax treaties involved across borders are complicated and cumbersome. Knowing where to start and identifying how it all affects you can be daunting. Each case is truly unique. We have identified a number of issues and planning strategies for most of the relevant ways the U.S. tax system may affect you, but even this paper is not exhaustive. It is vital you seek professional expertise from qualified cross border tax and/or legal professionals. We encourage you to engage your RBC advisor to help navigate you through your specific situation and engage the proper professionals as needed.

Footnotes

1) National Post newspaper, "Foreign buyers taking over – this time it's Canadians in Florida", September 16, 2014. Available at: "http://business.financialpost.com/personal-finance/mortgages-real-estate/foreign-buyers-taking-over-this-time-its-canadians-in-florida#__federated=1".

2) Bureau of Consular Affairs (CA), "Who We Are and What We Do: Consular Affairs by the Numbers", May 2014.

3) 2011 Canadian Census. Available at: "http://www.12.statcan.ca/census-recensement/2011/as-sa/98-310-x/tbl/tbl1-eng.cfm".

4) STEP Inside, May 2011.

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