Understanding your neighbour

Edward Northwood, March 2010

Edward Northwood TEP is an Attorney at The Ruchelman Law Firm.

As with most international tax planning, the key to cross-border Canada/US tax and estate tax planning is to synchronise the timing of the tax events and the taxpayer in order to minimise, and even eliminate, double taxation. Avoidance of tax in one jurisdiction may not be a satisfactory solution if it is merely a deferral or a shifting of a tax burden to a different taxpayer who or which may be subject to tax at a lower rate (as well as a later time).

Canadian personal tax overview

Federal income tax is imposed on resident individuals, estates, trusts and companies based upon residency or domicile in Canada. Canada has an extensive array of dual tax treaties, so in many cases tax residency may be overridden by a treaty. If a resident, tax may be imposed on one's worldwide income, which, of course, is determined under specific definitions.

Capital gains are taxed in Canada by applying the income tax rates only to a portion of the gain. Currently, an amount equal to 50 per cent of the gain earned on the disposition of capital property over its adjusted cost bases is included in income. Transfers of capital property, whether or not for consideration, trigger capital gains. This includes all capital assets owned by a decedent at death. There is, however, no gift, estate or other inheritance tax.

The Canadian provinces and territories apply separate tax, in virtually every case this is a surcharge to the federal income tax and is based on federal determinations of net income. The rates and tax brackets vary among the provinces and territories. Quebec has a separate system, although there is much in common with the federal tax system.

Canada imposes an exit tax when an individual or trust ceases to be resident in Canada. Thus, all of the individual's or trust's assets are deemed sold and accrued income items realised. However, assets that are situated in Canada, such as real property and retirement accounts, are not immediately subject to Canadian income tax on one's departure, because the tax may be collected (either as a non-resident tax or as a withholding tax) when a tax event occurs later.

As an alternative to inheritance tax, Canada imposes a deemed realisation income tax on one's death, the ultimate exit tax, if you will. Each deceased taxpayer is deemed to have disposed of his capital property immediately before death. This includes the recognition of all accrued items of income, such as Canadian deferred compensation arrangements and annuities. The primary exception to the death tax is a rollover of property that passes to the deceased taxpayer's spouse or to a qualifying spousal trust. This is merely a deferral, because the income tax is imposed no later than upon the surviving spouse's death.

US personal tax overview

Two major tax regimes apply to US domiciliaries (permanent residents) and US citizens. First, not only is their worldwide income subject to tax in accordance with US rules, but also they may be subject to special 'phantom' income taxes and/or punitive rates and interest charges, where they are shareholders of non-US corporations or beneficiaries of non-US trusts. Second, their gratuitous transfers of any assets during lifetime are subject to the US gift tax system and their worldwide estates are subject to US estate tax upon their death. Both the gift tax and the estate tax are value based taxes.

Most problematic on the income tax side are the so-called anti-deferral regimes. If a US taxpayer is a shareholder of a foreign corporation that generates passive income, then it may be subject to either the controlled foreign corporation (CFC) rules (where US taxpayers own more than 50 per cent of the company) or the passive foreign investment company (PFIC) rules, which basically apply to foreign companies that are primarily holding companies for portfolio and similar passive investments. Both situations are common in Canada-US cross-border situations due to the benefits in Canada of utilising holding companies.

Under 2009 law, if a US person's taxable estate is less than USD3,500,000, the estate would be exempt from US federal estate tax. On taxable estate values above the exemption, the federal estate tax rate is 45 per cent.1 Many states have separate estate or inheritance tax laws.

US estate tax for Canadians

Canadians who are not US citizens will be subject to the US gift tax and US estate tax regimes only with respect to their 'US situs assets.' US situs assets for gift tax purposes include interests in real property and tangible personal property (generally, the contents of real property but including boats and vehicles) that are located in the US. Both of these types of assets, plus shares of US stocks and debts of US persons or companies, are subject to US estate tax. Most US bonds, US bank accounts and US life insurance policies are expressly excluded by Code provisions.

Unlike a US citizen or resident, however, a Canadian who transfers an asset that is subject to US gift tax (such as an interest in US real property) has no exemption to avoid the actual payment of gift tax. All that is available to reduce the gift tax liability are the annual exclusions [USD134,000 in 2010 for outright gifts to a non-US citizen spouse; USD13,000 to all others].

Estate tax relief is available to Canadians under the Tax Treaty. For example, a Canadian's estate is entitled to a fraction of the US estate tax exemption (actually, a fraction of the unified credit), as well as a marital credit, which effectively doubles the exemption. Thus, Canadians who die owning US property or stocks and who are survived by a spouse, would not pay US estate tax if their worldwide estate is less than USD6,700,000.

A sampling of cross-border planning strategies and techniques

Use of trusts for US persons inheritance

A US child of a Canadian parent may keep the value of her or his inheritance, and the growth thereon, outside of her or his estate (that would be subject to US estate tax upon the child's later death) by having the inheritance pass in trust for the child and his or her family. Distributions from such a trust will allow the child's children to also escape the US gift tax regime. The total amount of inheritance passing to a child, which would be allowed to be set aside in such a 'generation skipping' (or 'dynasty') trust, is essentially unlimited under US tax rules for Canadian parents.

Avoidance of anti-deferral regimes as to gifts and inheritance

Planning for gifts and bequests to US persons from Canadians should also take into account the US person's exposure to the foreign corporation anti-deferral regimes referred to above (CFC and PFIC). It is also important to recognise that capital dividends paid by a Canadian corporation to a US taxpayer are not tax-free in the US. (They are, however, eligible for the favourable 'qualified dividend' rate in the US, in most circumstances). The income tax problems that have the potential to be the most serious arise in connection with Canadian holding companies, which comprise portfolio investments and non-actively managed real estate investments. As such companies are going to pass to family members, the majority of which are US taxpayers, such companies will be CFCs upon the parent's death, which gives rise to immediate 'phantom income' at no favourable rates of tax. If the US beneficiary will only receive a minority interest, then such person will end up being the shareholder in a PFIC.

> *"The key to cross-border planning is to synchronise the timing of the tax events and the taxpayer"*

One method of maintaining corporate status for Canadian purposes, while ensuring that the US beneficiaries do not receive or inherit a CFC or PFIC, would be to utilise an unlimited liability company. Such a vehicle is treated either as a partnership or a disregarded entity (depending on whether there is more than one shareholder) for US purposes, which means that neither the CFC nor

the PFIC rules will apply. Of course, such a vehicle would not be appropriate in Canada if the company had exposure to claims

US individuals moving to Canada

Canada's pre-immigration trust rules are available to US immigrants. If the US person moving to Canada is a US citizen who is not expatriating, then the pre-immigration trust may be utilised. This can be used not only to avoid Canadian taxation on the trust earnings in the first five years, but also to prevent US entities, which otherwise may not get favourable treatment under the Treaty, being sheltered from such problems for the five year period. Investments in limited liability companies (LLCs) are a common example. Because such interests that are held in a pre-immigration trust are not subject to tax in Canada for the individual's first five years of Canadian residency, plans may be made for the disposal or restructuring of such interests during the five year period.

Canadian individuals moving to the US

On the income tax side, it is generally preferable to avoid the imposition of the PFIC and CFC rules. Therefore, most interests in non-publicly traded companies should be disposed of prior to immigration. This is less of an issue with active companies, but investment holding companies should either be liquidated or transferred to other family members prior to immigration.

All interests in trusts should be reviewed to determine if there is any exposure to US income tax that the immigrant would like to avoid. The immigrant could consider moving the situs of any such trust to the US to avoid the punitive system that applies to certain foreign trusts.

Before becoming domiciled in the US, wealthy Canadians should transfer and restructure some of their asset holdings prior to becoming subject to the US gift and estate tax system. The current exemption from estate taxes for US citizens and US domiciliaries is USD3,500,000. Therefore, a married couple whose total net worth (including the death benefits on insurance policies that they own and interests in certain trusts) should reallocate ownership between themselves separately and then provide wills that, on the first death, would leave that decedent's estate in trust for the survivor. The wills should utilise terms that would ensure that the value of the trust would not be considered part of the survivor's estate for estate tax purposes, but for US estate tax purposes.

Where the pre-immigrant's assets significantly exceed the USD3,500,000 per person threshold, the easiest step to remove assets from the estate tax base is for one of the immigrants to create an irrevocable trust for the benefit of such immigrant's spouse and other family members prior to moving to the US. As with the testamentary trust, this trust agreement can be designed to enable the spouse or other family member to be the trustee as well as the beneficiary, but to have the value of the trust excluded from all family members' estates (including that of the settlor and the spouse) upon their deaths.

1. At the time that this article was prepared, the US estate taxes had been repealed. Under current law it will return in 2011 with a lower exemption and higher rates. This article assumes that the 2009 exemption and rates will be extended.