CANADIAN – U.S. TAX PLANNING
FOR INDIVIDUALS, SOME SELECTED ISSUES

Prepared for STEP USA/NEW YORK STATE BAR ASSOCIATION

13TH Annual International Estate Planning Institute
New York
March 23, 24, 2017

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February 10, 2017 (Submitted)
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Neither the author nor Cadesky and Associates LLP, or any related entity, can accept any responsibility for persons who act upon any matter discussed in this paper.

This paper does not constitute professional advice and is not a substitute therefor. Tax laws are complex, subject to frequent change, and open to interpretation. Professional advice should always be obtained.
Introduction

This paper discusses tax planning opportunities and traps and pitfalls in connection with Canada–U.S. taxation matters for individuals and families. The inspiration for the paper is the relevance of the subject. Canada and the U.S. are the largest trading partners in the world, and share the longest undefended border (at least for now). The countries have had a special relationship for a very long time, and this has led to considerable interest in Canada-U.S. tax planning matters. Canadians have family members in the U.S. and vice versa. Canadians own real estate in the U.S. and vice versa. Many Canadian families have investments in the U.S. and may have family members who have moved to the U.S. for business or lifestyle reasons. Canadians will sometimes look to retire in the U.S. In addition, there is an estimated one million U.S. citizens living in Canada, who need to consider both Canadian and U.S. tax issues.

Both countries have comprehensive and very complex tax systems. Adding to these complexities is the fact that the Canadian tax system is in many ways fundamentally different to the U.S. tax system, making tax planning challenging but also, in certain circumstances, very rewarding. The fundamental differences in the tax systems of the two countries lead to a very real potential for double taxation, which can be very punitive. The complexities of working with Canadian and U.S. tax rules in tandem with one another can lead to many traps and pitfalls for the unwary on a scale most people would never imagine.

The Canada-U.S. Treaty¹ attempts to bridge the gap between the tax systems of the two countries, to avoid double taxation, and to provide a rational tax result. It is an international tax treaty like no other. While it has at its heart the OECD model International Tax Treaty, it has been revised many times and has numerous unique provisions which have been custom drafted. It is therefore not possible to conclude that Canada-U.S. tax planning follows a typical model.

To provide appropriate advice, expertise is needed on both sides of the border. This expertise is not easily found, and is typically beyond the range of practice areas of most Canadian and U.S. tax practitioners. Added to this is the fact that the international tax area is among the most

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¹ Canada-United States Tax Convention (1980) referred to in this paper as the Canada-U.S. Treaty and sometimes the Treaty.
complex of all tax areas. Furthermore, the area is becoming increasingly more difficult all the time, and is constantly changing. These trends show no prospect of abatement.

Many firms (typically large accounting and law firms) have considerable expertise in Canada-U.S. corporate matters, generally devoted to handling the tax affairs of multi-national corporations with businesses in both countries. However, in the personal tax area, which is arguably equally complex, there are far fewer tax practitioners by comparison, and many tend to be in smaller boutique firms where the expertise is strong domestically but often less so beyond the border. Therefore what is needed is collaboration.

This paper begins with a description of the Canadian tax system with particular reference to the differences between it and the U.S. tax system. Understanding these differences is vital to grasping the complexities of this area. The paper then looks at a variety of situations such as the following:

1) Canadian families looking to benefit U.S. resident persons.

2) U.S. families looking to benefit Canadian resident persons.

3) Canadian persons moving to the U.S.

4) U.S. persons moving to Canada.

5) Canadians owning U.S. assets.

6) U.S. persons owning Canadian assets (discussion limited mainly to real estate).

7) Estate planning for U.S. citizens living in Canada.

For each of these situations, a brief summary of the major points is given. This is not a substitute for qualified professional advice, and in practice each situation will be unique to its own facts.

Note that this paper focuses primarily on the Canadian issues involved with these topics, and does not propose to give a detailed technical discussion of U.S. tax issues.
A. Canadian and U.S. Tax Systems, a Comparison

The Canadian and U.S. tax systems have many similarities, but it is not necessary to dwell on these. What is more important is to look at the differences between the tax systems because, by knowing one system and understanding the differences with the other, one can gain a reasonably complete picture of both systems.

1. Basis of Taxation – Individuals

Canada levies taxation on an individual on the basis of residence. If an individual is resident in Canada, the individual is subject to tax on world income. If an individual is a non-resident, then the person is subject to Canadian taxation only on certain Canadian source income. The provinces in Canada follow the federal determination of residency, so that it is not possible for an individual to be resident in a province but not resident for federal income tax purposes or vice versa.

Canada has two concepts of residency for tax purposes, the first being a common-law concept and the second being a substantial presence type test.

If an individual has sufficient residential ties to Canada, then the person will be considered a resident. These residential ties include having a home available in Canada, having close family members living in Canada (a spouse and/or dependent children), spending significant time in Canada, having significant investments and/or sources of income in Canada and so forth. These can be viewed as primary ties. It may also be relevant to consider secondary ties such as club memberships, driver’s license, doctor, dentist, credit cards, bank accounts etc. It is also necessary to examine a person’s ties to another country, to form a complete picture of the individual’s normal daily life, before a determination of common-law residency can be made.

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2 Subsection 2(1) of the Income Tax Act (Canada). Section references are to the Income Tax Act (Canada) unless otherwise stated.
3 Subsection 2(3), section 115, and section 212.
4 The common-law doctrine is derived from the case of Thomson v. The Minister of National Revenue, 1945 C.T.C. 63 (Supreme Court of Canada). It is also explained in Interpretation Bulletin IT221R3, determination of an individual’s residence status, dated December 21, 2001 which sets out the views of the Canada Revenue Agency (the “CRA”). See also Form NR73 and NR74 published by the CRA.
5 See paragraph 250(1)(a). This test is often called the 183 day rule or the sojourner rule.
An individual who spends 183 days or more in Canada in a calendar year is deemed to be a Canadian resident for the entire calendar year. An individual who becomes a Canadian resident on the basis of establishing residential ties to Canada will be considered resident from when those ties are established, and therefore may be a part year resident.⁶

A Canadian resident individual who becomes a non-resident will be subject to a similar residency determination which will examine the severing of ties to Canada and the establishing of ties to the foreign country.

The Canadian common-law determination of residency and the substantial presence determination are both overridden where an international tax treaty is relevant. Where an individual would otherwise be a Canadian resident under either of these tests, the individual will be deemed a non-resident of Canada if resident in a country with which Canada has an international tax treaty and, under the terms of the tie-breaker article in that treaty, the individual is a resident of that foreign country.⁷ Thus an individual with significant residential ties to Canada may nevertheless be considered a non-resident if a treaty determination leads to this conclusion.

The Canada–U.S. Treaty provides for such a tie-breaker test, which will be relevant at any time the individual is a U.S. resident firstly under U.S. domestic law (so as to come within the treaty itself) and then as determined under the tie-breaker provisions of the Treaty.⁸ This rule is codified in Canadian tax legislation in the form of a deeming provision which is non-rebuttable.

The tie-breaker test in the Canada-U.S. Treaty is typical of Canada’s international treaties, and requires a determination of the following:

i. If a person has a permanent home available only in one country and not the other, then the person will be resident in that country.

ii. If the person has a permanent home available in both countries or neither country, then the determination is made by where the person’s personal and economic interests are closer (center of vital interests).

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⁶ Section 114
⁷ Subsection 250(5).
⁸ Article IV in paragraph 2.
iii. If the person’s center of vital interests cannot be determined, then the person is considered resident where he or she has a habitual abode.

iv. If the person has a habitual abode in both countries or neither country, then the person is considered resident where he or she is a citizen.

v. If the person is a citizen of both countries or neither country, then the person is considered resident where the competent authorities of the two countries so determine.

The treaty tie-breaker test is very important because it can:

i. Provide an objective arbitration of where the person is resident, such that the person cannot be a dual resident (which would be the case in certain circumstances absent an international tax treaty).

ii. Provide guidance as to when the individual became or ceased to be a Canadian resident.

iii. Accommodate the existence of certain ongoing ties to Canada which might otherwise result in the person being considered a Canadian resident, but which are overridden based on the tie-breaker test.

iv. In certain cases, lead to a result where one spouse is a resident of Canada while the other is not (which would normally be a difficult position to sustain absent the tie-breaker test).

2. **U.S. Residency – Income Tax**

At the federal level, there are two tests of residency, the green card test and the substantial presence test. An individual holding a U.S. green card will normally be considered a U.S. resident, absent the possible intervention of an international tax treaty which might override this result. An individual who is physically present in the U.S. for 183 days or more in the calendar year will be considered a U.S. resident under the substantial presence test, absent certain unusual circumstances (a student visa, involuntary medical circumstances etc.). In addition, the substantial presence
test is extended to a three year weighted average where the individual does not have closer connections to a foreign country in the year.

This description of the U.S. green card test and the substantial presence test is not intended to be exhaustive, but merely illustrative, to show the fundamental differences between Canada and the U.S. in the determination of residency. These can potentially lead to the following implications:

1) An individual could be a non-resident of Canada and also a non-resident of the U.S. This result would arise where the person has severed all significant residential ties to Canada, and is living in the U.S., but does not meet the substantial presence test in that year. Consequently, the person would be resident in neither country. In such a case, the Treaty would not be applicable so the tie-breaker test would not operate.

2) The individual may be a dual resident, because the individual meets the residency tests of both countries, and residency under the treaty is arbitrated in favour of Canada. (Note that if residency under the treaty was determined to be in the U.S., then the individual would be deemed a non-resident of Canada, but the U.S. does not have a similar rule.)

3) There can be differences between the countries as to the date at which a person’s residency status changed.

In addition to considering U.S. federal rules, the various states of the U.S. may use different tests to determine residency. Some states use a facts and circumstances test, and others use a habitual abode test or ownership of a home in the state. This can lead to a result where the person may be resident for federal purposes and not for state purposes, or the other way around.

3. **U.S. Residency - Estate and Gift Tax**

Neither Canada nor any province or territory in Canada has estate and gift tax. Accordingly there is no separate residency determination for this purpose. However, the U.S. does currently have an estate and gift tax system and uses a different concept of residency for this purpose. It is therefore possible that an individual could
be resident in the U.S. for income tax purposes (and likely a non-resident of Canada as a result), but not resident for estate and gift tax purposes. This is significant because:

1) An individual resident in the U.S. for income tax purposes who is not resident for estate and gift tax purposes may be able to carry out certain planning for estate and gift tax purposes while being a non-resident of Canada.

2) An individual who is living in the U.S., and a non-resident of Canada, but who is not resident for U.S. estate and gift tax purposes, will be taxable only on U.S. situs property in the event of death, and on gifts of U.S. real property. Nevertheless, this may not be advantageous because such a person will be entitled only to the exemption granted to non-resident aliens ($60,000), and not to the enhanced exemptions from estate tax as provided under the Canada-U.S. Treaty (discussed later) or U.S. domestic law applicable to citizens and residents (for estate and gift tax purposes).

4. **Canadian Individual – Computation of Income**

Canada has a comprehensive system of determining income, which includes income from all sources, both Canadian and foreign. All items of income less applicable deductions are totalled to come to taxable income. Tax is then calculated on this taxable income according to graduated tax rates. One set of rates is applicable for federal purposes, and another for provincial purposes. There is some variation in tax rates across Canada.

There are, broadly speaking, five categories of income being employment income, business income, property income, capital gains, and other income.

The computation of income and tax is similar, but not identical to that of the U.S. Major differences include the following:

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9 Section 3.
• In certain circumstances, the benefit subject to tax from exercising a stock option is reduced to 50% of the economic benefit.\textsuperscript{10}

• 50% of a capital gain is included in income (the taxable capital gain), while 50% of the capital loss can be deducted against taxable capital gains.\textsuperscript{11}

• There is an unlimited exemption on the gain realized from the sale of a principal residence, subject to certain limitations concerning the area of land which may be included. There is no monetary limit to the amount of gain which can be exempted.\textsuperscript{12}

• Gains from the sale of shares of Canadian controlled private corporations which carry on an active business primarily in Canada are exempt of tax up to approximately $824,000 per individual (lifetime exemption). Certain farming and fishing properties also qualify.\textsuperscript{13}

• Donations are granted tax relief, but (for an individual) as a tax credit rather than a deduction. This tax credit is given at the top tax rate (with minor modifications).

• Provincial income tax is not deductible.

• Mortgage interest and property taxes are not per se deductible. However, interest is deductible if the purpose of the borrowing is to earn income.

• Dividends paid by taxable Canadian corporations are subject to a special computation where, depending on the dividend, 117% or 138% is included in income, and a special tax credit is given. This reduces the tax rate on such dividend income to compensate for the corporate tax paid.\textsuperscript{14}

\textsuperscript{10} Section 7 and paragraph 110(1)(d)
\textsuperscript{11} Section 38
\textsuperscript{12} Paragraph 40(2)(b) and section 54 (definition)
\textsuperscript{13} Section 110.6. The exemption was $800,000 in 2014 and be indexed after that. Farming and fishing properties meeting certain conditions will qualify for an exemption of $1,000,000 for dispositions after April 20, 2015.
\textsuperscript{14} Subsection 82(1)
• Losses may be carried back three years and carried forward indefinitely if they are capital losses and for 20 years otherwise.\textsuperscript{15}

• No joint filings are allowed for spouses or common-law partners. Each individual files an income tax return separately and there is only one set of tax brackets and rates. There are certain rules which may attribute income from one spouse to another and from minor children to related persons.\textsuperscript{16} There is also a kiddie tax system which applies to dividends from private corporations, business or rental income, and capital gains from the disposal of shares of private corporations to non-arm’s length persons. The kiddie tax ceases in the year the person becomes eighteen.

• Unlike the U.S., Canada does not have passive activity loss restrictions as such. There are, however, certain limitations on the deductibility of certain expenses such as depreciation and an alternate minimum tax system.

• There is no concept of itemized deductions or a standard deduction in lieu.

The Canadian income brackets are graduated like the U.S. brackets, but the top tax rate is reached at a lower level of income and the rates are generally higher.

Unlike the U.S., there are no special low income tax brackets for such things as capital gains and qualifying dividends. However, at low tax brackets, the tax credit given to Canadian taxable dividends allows an individual to pay no tax or virtually no tax on such dividend income.

Canada has a system of alternate minimum tax, with a $40,000 exemption.\textsuperscript{17} The tax preference items listed for alternate minimum tax are less pervasive than those in the U.S., and the tax rate is lower, relatively speaking. As a practical matter, most individuals do not pay alternate minimum tax. If alternate minimum tax is paid, it can be carried forward for up to seven years to be used in a year where regular tax exceeds alternate minimum tax.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{15} Section 111
\item \textsuperscript{16} Sections 74.1, 74.2, 74.3, 74.4, 74.5, and 120.4
\item \textsuperscript{17} Section 127.5
\end{itemize}
\end{footnotesize}
5. **International Aspects**

In the international area, the Canadian tax system is quite different to that of the U.S. These differences are fundamental, and form an important part of Canada-U.S. tax planning for individuals both to obtain beneficial results and to avoid adverse consequences of double taxation.

Upon becoming a resident of Canada, a revaluation or step-up is given in the tax cost of most assets but not taxable Canadian property.\(^{18}\) This means that gains accruing prior to becoming Canadian resident are not subject to Canadian tax. If the value of a property has decreased below its original cost for tax purposes, the property is valued downwards for Canadian tax purposes to its value at the date the individual becomes resident. Thus, the so-called step-up can also result in a “step-down”.

In this connection, it is important to understand the definition of “taxable Canadian property”.\(^{19}\) Such property is not subject to a step-up (or step-down) at the time of becoming Canadian resident.

Taxable Canadian property currently includes real property situated in Canada, certain assets used in a business carried on in Canada, and shares, trust interests, and partnership interests (both Canadian and foreign) where the value is derived primarily (i.e. more than 50%) from real property situated in Canada, Canadian resource properties, Canadian timber resource properties, or options or interests in these.

The definition was significantly altered on March 4, 2010 and prior to this date included shares in Canadian private corporations and, in some cases, in public corporations, as well as a capital interest in a trust resident in Canada. The old definition remained in place for 60 months from March 4, 2010 in certain cases but is now gone.

The corollary to a step-up on arrival is a deemed disposition on departure. Where an individual becomes non-resident, that individual is deemed to sell all property owned at that time, for fair market value, with very limited exceptions.\(^{20}\) For capital property, this will result in capital gains. For other types of property, this may result in the recognition of income.

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\(^{18}\) Subsection 128.1(1)

\(^{19}\) The definition is contained in subsection 248(1)

\(^{20}\) Subsection 128.1(4)
There are certain limited exceptions from the departure tax which include:

- an interest in a trust resident in Canada
- Canadian real property which is held personally
- stock options
- interests in various types of retirement plans

There is also an exemption for an individual who becomes non-resident and has not been resident in Canada for 60 months in the past ten years, but only for property that was owned at the time of becoming resident, or received after becoming resident by inheritance or bequest.21

Because the disposition on departure is deemed to arise immediately before the individual becomes non-resident, and an individual cannot be a dual resident for Canadian income tax purposes where an international tax treaty is applicable, no treaty relief is available by the capital gains article of the Treaty to override the departure tax.

Where an individual has a deemed disposition on departure, the tax resulting from the deemed disposition may be postponed until an actual sale or disposition of the property provided security is furnished for the tax.22 In this circumstance, no interest is payable in respect of the tax, but the amount of tax is determined and fixed by reference to the value at departure. If the property subsequently decreases in value, it is not possible to carry back a capital loss against the capital gain realized on departure, unless the property is taxable Canadian property.23 With the more limited definition now in effect, the benefit of this capital loss will often be unavailable in Canada. Even if the capital loss results from the disposition of taxable Canadian property, so that it may be applied against the capital gain on departure, other limitations also apply. One is that the capital loss is limited to a three-year carryback. Another is that where dividends have been paid, a loss restriction rule can apply to reduce the loss by the amount of dividends withdrawn. This prevents planning where

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21 Subparagraph 128.1(4)(b)
22 Subsection 220(4.5)
23 This results through the interaction of sections 115 and 111.
a loss is deliberately structured post-departure through stripping assets out of a corporation.

The reason for certain exemptions from the departure tax is that Canada still retains the ability to tax income and capital gains from these sources (including capital gains from disposition of the assets), either under the regular income tax system\(^\text{24}\) (an income tax return filed by a non-resident), or under the non-resident withholding tax system\(^\text{25}\).

Relief from double taxation caused by the deemed disposition on departure can be granted in two ways.

Where shares that are taxable Canadian property are redeemed after departure, producing a deemed dividend subject to non-resident withholding tax, a special tax credit may be taken against the tax from the capital gain on departure. This tax credit applies only to federal tax and has certain limitations\(^\text{26}\).

Where a property was subject to a deemed capital gain on departure, and is later sold by the individual as a non-resident, the tax paid to the foreign country may be claimed in Canada as a tax credit\(^\text{27}\). This applies only to the portion of the gain subject to the foreign tax that arose before departure and there are several additional conditions. There is no time limit imposed, so a disposition say 10 years or more after departure is still eligible for credit against the Canadian tax for the year of departure. This relief is very often overlooked.

6. **Foreign Income**

Canada has a comprehensive system for taxing international income, whether the income is earned directly or indirectly. Where foreign income is earned directly, it is included in income in the regular way, and a foreign tax credit may be claimed, subject to certain limitations\(^\text{28}\). Where the income is earned indirectly, say through a foreign

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\(^\text{24}\) Section 115  
\(^\text{25}\) Section 212  
\(^\text{26}\) Section 119  
\(^\text{27}\) Subsection 126 (2.21)  
\(^\text{28}\) Section 126
corporation or a foreign trust, Canada has a series of rules which may tax the income depending on its nature and the surrounding circumstances.

It should be noted that while Canada has subpart F type rules, Canada does not have PFIC rules as such. There were proposals to implement such rules, and draft legislation was developed, but it was subsequently abandoned.  

Unlike the U.S., Canada does not have a concept of a flow through entity, except in the case of a partnership and, to some extent, a trust. Partnerships are always flow-through entities, allocating their income to the partners, and corporations are always taxed on their income at the corporate level at corporate rates (with a very few special exceptions in very narrowly defined circumstances).

U.S. LLCs pose a particular challenge because, for Canadian income tax purposes, these are viewed as corporations whether or not they are flow-through entities for U.S. purposes. Recently the CRA also announced that limited liability limited partnerships would be treated as foreign corporations.

Canada’s subpart F rules, known as the foreign accrual property income or FAPI rules, start with a determination as to whether the foreign corporation is a controlled foreign affiliate. For this purpose, the corporation must be a foreign affiliate of the Canadian taxpayer first. Generally speaking, a foreign corporation will be a foreign affiliate of a Canadian taxpayer if that person holds 10% or more of any class of shares. A foreign affiliate will be a controlled foreign affiliate if it is controlled by four or fewer Canadian resident persons, or by a combination of such Canadian resident persons and non-arm’s length foreign persons. While this is an over simplification of the definition, it will act as a general guideline, in lieu of analyzing the more specific rules.

The analysis then continues with an examination of the income of the controlled foreign affiliate, to determine whether any component of the income is foreign accrual property income or FAPI. As will be expected, these rules are complex in nature, and require expert advice. In simple terms, however, investment income (interest, dividends, rents, royalties, and capital gains) will be FAPI unless an exception applies. Certain active business income may also be considered FAPI, in accordance with

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29 Major amendments to section 94.1 dealing with foreign investment entities were ultimately abandoned.
30 The rules and definitions are contained in section 95.
specific rules. Most importantly, certain income from services, certain trading profits and profits from an adventure in the nature of trade may be FAPI in some circumstances. Inter-corporate transactions between foreign affiliates are generally exempted from the FAPI rules.

The proportionate share of FAPI is included in the income of the Canadian resident shareholder, and relief is given for foreign tax paid in the form of a “gross up” deduction. As a general rule, if the foreign tax paid is equivalent to what would have been paid by the Canadian shareholder on the same income, no amount will be included overall in income as FAPI. However, there are exceptions and anomalies, particularly in dealing with U.S. LLCs. Because in the case of a U.S. LLC, the tax is paid at the owner or shareholder level (unless it is designated as a corporation), it appears that no relief is given under the FAPI rules for this tax. An individual may claim a foreign tax credit but a Canadian corporation generally may not.

As mentioned above, the FAPI rules result in considerable problems in Canada-U.S. tax planning, particularly where a U.S. LLC has FAPI.

Canada uses a common law mind and management test to determine whether a foreign corporation is Canadian resident. If the central management and control of the foreign corporation is exercised from Canada, then absent a specific overriding provision in an international tax treaty, the foreign corporation may be deemed to be resident in Canada and taxed on its world income as a result. The Treaty will deem a U.S. corporation to be solely U.S. resident, but this does not extend to a U.S. LLC. Thus for a U.S. LLC, the mind and management question is an important one. If it is in Canada, the LLC could be deemed a Canadian resident corporation and taxable on world income.

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31 Most types of active business income will be outside of the FAPI rules but complex rules apply especially where the income is derived from real estate or financial services.
32 Inter-corporate dividends between foreign affiliates and inter-group charges for rent, interest expense, management fees and royalties.
33 The issue arises because the tax is not paid by the foreign affiliate itself but by the owner and therefore does not come within the definition of foreign accrual tax in section 95.
34 Garron Family Trust v. R. [2012] 3 C.T.C. 265 (Supreme Court of Canada).
35 A U.S. corporation is exempt of this issue as it is specified to be a U.S. resident under Article IV, paragraph 3(a). This rule does not extend to a U.S. LLC which does not elect to be treated as a corporation for U.S. tax purposes.
7. **Taxation of Foreign Trusts**

A trust will be considered resident at common law where its trustees are resident, provided they exercise management and control. If the management and control of the foreign trust is exercised from Canada, then the trust may be a resident of Canada as a result even if the trustees are non-resident. With proper planning and execution, this should never occur. However, Canada has a second set of rules concerning foreign trusts which overlay on the common law concept of residency.\(^{36}\) These rules concerning non-resident trusts have been in a state of change since amendments to the rules were announced in 1999. After several rounds of draft legislation, which have postponed the transitional dates several times, the new rules became law in 2013 and apply from January 1, 2007 onwards. Under these rules, a non-resident trust to which a Canadian resident person has contributed property, directly or indirectly, will be deemed a Canadian resident regardless of who the beneficiaries are or where they are resident. An exception applied for property contributed by an individual who has not been resident in Canada for, in the aggregate, 60 months but this was withdrawn in 2014. This planning used to provide an important exemption for persons who have not previously been resident in Canada, or have been resident for only a short time by using a non-resident trust.

Where a non-resident trust has received property from both a Canadian resident and a non-resident, the income is to be apportioned in a reasonable way such that only the portion related to property contributed by the Canadian resident is subject to tax.\(^{37}\)

The deemed residency rule ceases if the contributor is no longer a Canadian resident, either through death or becoming a non-resident, provided the trust has, generally speaking, no Canadian resident beneficiary (or the ability to add a Canadian resident beneficiary related to the contributor). This rule thus provides an exemption for non-resident trusts which no longer have a Canadian connection (i.e., no resident contributor and only non-resident beneficiaries).\(^{38}\)

\(^{36}\) Section 94.

\(^{37}\) This rule is contained under the new legislation. Under the old legislation before 2007, any contribution however nominal, from a Canadian resident could deem the trust to be resident and taxable on its income in full if the further conditions of subsection 94(1) were also met. The new rules allow an apportionment.

\(^{38}\) Under the legislation, a beneficiary who is “a successor beneficiary”, as defined in subsection 94(1), is not taken into consideration even if the person is resident in Canada. In general terms, this is a person who may only benefit
Of significance is that where a non-resident trust which was previously deemed Canadian resident ceases to be so because of the death or departure of the Canadian resident contributor, the trust is deemed to sell its assets at that time at fair market value.\textsuperscript{39} This results in a deemed disposition analogous to departure tax but with no election to postpone the payment of tax through furnishing security.

These non-resident trust rules are designed to prevent Canadian resident persons from avoiding Canadian tax through the use of non-resident trusts, other than in circumstances where rules specifically allow for exemptions.

Prior to the new rules, which are effective from 2007 onwards, a non-resident trust would only be deemed Canadian resident if three conditions were all met,\textsuperscript{40} which were:

1) A Canadian resident transferred property to the trust (in any amount even a nominal contribution)

2) There is a Canadian resident beneficiary of the trust, or the possibility of adding one or more Canadian resident beneficiaries related to the contributor

3) A Canadian resident contributor is related to at least one beneficiary (including himself or herself, and the rule is extended to include “aunts”, “uncles”, “nieces” and “nephews”).

A trust not resident under the rules before 2007 but resident under the new rules will obtain a step-up in the cost of its assets (other than taxable Canadian property) at December 31, 2006.

Before 2007, if a former Canadian resident establishes a non-resident trust within 18 months of becoming non-resident, and the trust has Canadian resident beneficiaries or the possibility of adding such persons, the trust will be deemed to be a Canadian

\textsuperscript{39} Subsection 94(5).
\textsuperscript{40} Paragraphs 94(1)(a) and (b) of the old legislation.
resident from inception.\textsuperscript{41} This 18 month rule is extended after 2006 to 60 months for an inter vivos trust but remains at 18 months for a testamentary trust.\textsuperscript{42} Thus an inter vivos trust created by a non-resident within 60 months of leaving Canada, with a Canadian resident beneficiary or the ability to add such a person, will be deemed resident. Certain limited exceptions apply.\textsuperscript{43}

An individual who becomes a Canadian resident and who has previously contributed to a non-resident trust (including a U.S. trust) will discover that this trust is deemed to be a Canadian resident, not from arrival but from January 1 of that year.\textsuperscript{44} If such a trust had Canadian resident beneficiaries and the individual made a contribution within 60 months of becoming resident, the trust may be deemed Canadian resident from January 1 of the year of the contribution (potentially retroactive up to 5 years).\textsuperscript{45} This is an odd result but technically correct as a function of the way the rules are drafted. It is hoped that this will be corrected as it is obviously inappropriate.

The rules concerning non-resident trusts are complicated, and have numerous technical provisions. For example, there are rules concerning certain indirect transfers which are far-reaching. Rules also provide that international tax treaties may not override the residency determination of a non-resident trust under these domestic rules.\textsuperscript{46} Thus under Canadian domestic law these rules override international tax treaties, although it is debatable as to whether a Canadian court would uphold this. Prior to the new rules, it was possible that an international tax treaty could override the domestic rules through the trust being considered non-resident per the treaty.

\section{Taxation of Canadian Trusts Generally}

A Canadian personal trust (as opposed to a commercial trust or mutual fund trust) is taxed as an individual in accordance with normal Canadian rules, subject to certain obvious modifications.\textsuperscript{47} An inter vivos trust is taxed at the top tax rate, while a testamentary trust is taxed at the graduated tax rates applicable to natural individuals

\textsuperscript{41} Subclause 94(1)(b)(i)(A)(II) of the previous legislation.

\textsuperscript{42} This result arises through the definitions of resident beneficiary and non-resident time in subsection 94(1).

\textsuperscript{43} See definition of successor beneficiary in subsection 94(1).

\textsuperscript{44} This results from the operation of subsection 94(3).

\textsuperscript{45} This strange result occurs because of the definitions of “resident beneficiary” and “non-resident time” in subsection 94(1).

\textsuperscript{46} Section 4.3 of the Income Tax Conventions Interpretation Act deemed to have become effective on March 5, 2010.

\textsuperscript{47} The main rules concerning the taxation of trust are contained in sections 104 to 108.
but without personal exemptions if it meets certain conditions and then only for its first 36 months.\textsuperscript{48}

A Canadian resident trust may retain its income and pay tax in the trust accordingly, or distribute some or all of its income in which case tax is paid by the beneficiaries. Most components of income retain their character, although there are a few exceptions. Even if the trust pays out its income (say because this is required under the terms of a Will), an election is available where the income can be taxed in the trust in an amount which is designated. From 2016 onwards this election is severely restricted.\textsuperscript{49}

Rules similar to the U.S. grantor trust rules can impute the income of the trust to a Canadian resident who has transferred property to the trust.\textsuperscript{50} In normal planning, this rule is typically avoided by arranging for the person who contributed property to the trust by a settlement not to be a beneficiary or a controlling trustee. This attribution rule ceases when the person dies or becomes a non-resident. Also, from 2013 onwards, it does not apply to a non-resident (or deemed resident) trust.

Except in limited circumstances, it is not possible to transfer property to a trust without recognizing gains which are on hand. The main exception to this rule is for a spousal or common-law partner trust, which is a trust where the spouse or common-law partner is entitled to all of the income of the trust during that person’s life, and no other person may for such period obtain the use of the capital of the trust (called a spousal trust).\textsuperscript{51} In this case, a “rollover” or tax-deferred transfer is available to the trust, provided the trustees and both spouses or common-law partners are residents of Canada. A tax-free transfer may also be made by an individual to a trust under which the individual (alone or together with a spouse or common-law partner) is the beneficiary and has a life interest in the income, but only on or after age 65.\textsuperscript{52} Such trusts are referred to as alter ego and joint spousal trusts. An additional requirement is that no person other than the contributor or spouse may obtain the capital during that person’s lifetime. See the legislation for the exact details.

\textsuperscript{48} Starting in 2016, a testamentary trust will obtain graduated tax rated only for the first 36 months unless it has an infirm beneficiary.

\textsuperscript{49} The election under subsections 104(13.1) and 104(13.2) will only be available after 2015 if it results in taxable income of nil. In other words, it can only be used to absorb loss carry-forwards.

\textsuperscript{50} Subsection 75(2)

\textsuperscript{51} Subsections 73(1) in an inter vivos situation, in subsection 70(5) in testamentary circumstances.

\textsuperscript{52} Subparagraph 73(1.01)(e)(iii) and subsection 73(1.02)
Where a trust distributes property to a Canadian resident beneficiary, a rollout is permitted, such that no gain or loss is recognized by the trust.\(^{53}\) The beneficiary takes over the trust’s basis in the property. However, an election can be made for this transfer to occur at fair market value.\(^{54}\) Where the transfer is to a non-resident beneficiary, then the transfer always occurs at fair market value, with the exception of a distribution of Canadian real estate.\(^{55}\)

An important aspect of the Canadian taxation of trusts is the 21-year deemed disposition rule. Under this rule, the trust is deemed to sell its assets at fair market value every 21 years.\(^{56}\) This prevents an indefinite deferral of capital gains. This is important in Canadian estate planning. The rule applies not just to Canadian resident trusts, but also to deemed resident trusts, and non-resident trusts that hold taxable Canadian property. For a spousal, alter ego or joint spousal trust the deemed gain instead applies on death of the contributor (if alter ego), spouse (if spousal) or last to die of contributor and spouse (joint spousal).

Where income is retained in a trust, and later paid out as capital, the capital is not taxable in the hands of the beneficiary. Canada has no equivalent of the U.S. undistributed net income (or UNI) rules.

9. **Distributions from Foreign Trust**

Following from the discussion above concerning the Canadian tax treatment of non-resident trusts, it is important to understand how distributions from these trusts are taxed in the hands of Canadian resident persons.

For this purpose, a foreign trust needs to be characterized as either a deemed resident trust or a foreign (i.e. non-resident) trust under Canadian tax principles.\(^{57}\) A foreign trust is a trust not factually or deemed to be a Canadian resident trust (see discussion earlier).

\(^{53}\) Subsection 107(2).
\(^{54}\) Subsections 107(2.001) and (2.002).
\(^{55}\) Subsection 107(2.1), and subsection 107(5).
\(^{56}\) Subsection 104(4).
\(^{57}\) This is important because income which is distributed to a Canadian resident beneficiary will retain its character if the trust is Canadian resident or deemed Canadian resident, but not if it is a foreign trust.
A deemed resident trust is taxed similarly to a Canadian resident trust. If the income is retained in the trust, then the trust will pay tax on the income. If the income is distributed to a Canadian resident beneficiary, then that beneficiary will pay tax on the income.\(^{58}\) If the income is distributed to a non-resident beneficiary, then subject to certain limited grandfathering rules, the distribution may either be denied deduction in part or in full in the trust or be subject to non-resident withholding tax.\(^{59}\) This prevents the income of a deemed resident trust from being “dissipated” to non-resident persons, thereby escaping Canadian tax.

A Canadian resident who receives a distribution from a foreign trust must determine if the distribution is an income distribution or a capital distribution.\(^{60}\) If the distribution is an income distribution, it will be taxable as property income in the hands of the recipient. If the distribution is a capital distribution, it will not be taxable. Since Canada does not have a concept of undistributed net income, where a non-resident trust has earned income which has been retained over the end of a calendar year, the income will simply become capital for Canadian tax purposes.\(^{61}\) As a result, this income (now capital) may then be distributed tax-free to Canadian resident persons. This allows for a significant advantage, and opportunities for international tax planning.

Because the Canadian rules on distributing capital of the trust are fundamentally different from the U.S. rules (the UNI system), a serious mismatch can arise and double tax can result. This must be carefully considered in any international plan, because of the far reaching and adverse U.S. income tax implications.

10. **Canadian Estate Planning**

As mentioned earlier, Canada does not have an estate and gift tax system. Gifts, and property left at death, cause recognition of any accrued gains on hand. To achieve this, a deemed disposition results at fair market value. There is an exemption from this deemed disposition rule where property is left inter vivos or on death to a Canadian resident spouse or common-law partner (or a trust for that spouse or common-law

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\(^{58}\) Income distributed from a trust, Canadian or foreign, will be taxed in the hands of a Canadian resident beneficiary. Subsection 104(13) does not distinguish between a resident, a deemed resident and a non-resident trust.

\(^{59}\) This withholding might be reduced where an international tax treaty applies. See also subsection 104(7.01).

\(^{60}\) Subsection 104(13) which provides simply that the beneficiary shall include such part of the trusts income as became payable to the beneficiary in the year. In this connection, income would be computed in accordance with Canadian income tax concepts.

\(^{61}\) There is no specific rule dealing with the capitalization of income, but it is generally excepted practice.
partner which meets certain conditions as described above). Absent this, the transaction will take place at fair market value, regardless of the proceeds received. This deemed realization of capital gains but absence of gift and estate tax, both inter vivos and testamentary, is fundamental to Canadian estate planning.

Much of Canadian estate planning is devoted to deferring capital gains and passing these on to the next generation. This is often done through an estate freeze using a corporation and preferred shares. Because Canada does not have an estate and gift tax, and because of a generous administrative position of the Canada Revenue Agency, preferred shares can be used to “freeze” the value of a corporation, transferring the future growth through newly issued common shares. These common shares are typically issued to a trust, where they may remain for 21 years before the 21 year deemed disposition rule applies. Just prior to this date, it is usual for the shares to be distributed by the trust to beneficiaries.

In addition to this planning, certain tax strategies are often carried out post-mortem to relieve double taxation of corporately held assets.

This type of tax planning is problematic from a U.S. tax perspective because either:

- The freeze structure will result in gift tax, or
- The trust will be a grantor trust such that the common shares held by it will be property of the grantor.

So the choice may be gift tax or estate tax, and people normally opt for the latter. The result is usually no Canadian style estate freeze.

11. **Canada-U.S. Treaty**

The Canada-U.S. Treaty is very important in the tax planning involving these two countries. As mentioned earlier, the Treaty is not a standard OECD model treaty, because of the many provisions which have been custom drafted. This will become apparent from the outline below.
The treaty is applicable to persons who are resident in Canada or the U.S., with the important proviso that the treaty does not, generally speaking, limit the right of the U.S. to tax its citizens (and former citizens and former long term green card holders).  

The treaty also provides certain benefits to U.S. LLCs that are owned by U.S. persons which, absent this provision, would not be entitled to treaty benefits on the basis that a U.S. LLC is not a taxpayer unless it elects to be taxed as a corporation.

The treaty also contains the typical U.S. limitation of benefits provisions limiting the application of the treaty to persons who are “qualifying persons.”

Like Canada’s other international tax treaties, the Canada-U.S. Treaty contains the typical tie-breaker rule on residency, with certain extended provisions. This has been referred to earlier.

The U.S. does not normally allow a revaluation in the basis of property when a person becomes U.S. resident. However, a particular provision under the Canada-U.S. Treaty allows a revaluation for U.S. purposes where property has been subject to Canada’s deemed disposition rules. This is important for relief of double taxation.

Of particular significance is the withholding tax rate on income distributed from a trust. Where the income of the trust is foreign source, a withholding tax rate of nil is applicable. None of Canada’s other treaties provide for this.

A particular article of the treaty addresses U.S. estate tax and Canadian tax paid on death. These provisions allow a Canadian resident owning U.S. situs property to claim a pro-rated exemption based on the exemption available under U.S. domestic law. For example, if a Canadian resident owns U.S. situs property amounting to a value of 20% of the person’s total assets, on death, 20% of the normal U.S. exemption can be claimed. The exemption can be claimed twice, where property is left in part to a surviving spouse and also to others.

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62 Article XXIX paragraph 2.
63 Article IV paragraph 6.
64 Article XXIXA
65 Article XIII paragraph 7.
66 Article XXII paragraph 2.
67 Article XXIX-B.
68 Article XXIX-B paragraphs 2, 3, and 4. The exemption for 2013 is expected to be $5,250,000 U.S.
U.S. estate tax can be claimed for Canadian federal income tax purposes as a foreign tax paid.\textsuperscript{69} This is unique to the Canada-U.S. Treaty as normally under Canadian income tax rules a foreign tax credit is only allowed for foreign income taxes paid. Also, the U.S. will allow a credit for Canadian income tax paid on death by a U.S. person in respect of Canadian assets.\textsuperscript{70}

If President Trump’s promise to eliminate the U.S. estate tax becomes a reality, then these provisions may become largely irrelevant.

\textbf{B. Canada-U.S. Tax Planning}

From the vast body of rules discussed in the first part of this paper, one can theoretically deduce in broad terms some of the planning opportunities, and also the traps and pitfalls in Canada-U.S. tax planning for individuals. However, it is wishful thinking to believe that one could derive such planning with any degree of precision and reliability. The rules are very complex in theory, and even more complicated in practice.

For this reason, the second part of the paper builds on the concepts outlined in the first part, to illustrate certain of the major concepts and tax planning strategies.

\textbf{1. Canadian Families Wishing to Benefit U.S. Persons}

This section discusses the issues of a Canadian family wishing to benefit one or more family members living in the U.S.

Prior to 2007, it would have been possible to establish a non-resident trust, transfer assets to the trust, and have the trust accumulate income without Canadian tax, provided the trust did not have any Canadian resident beneficiary or the possibility of adding such a person.\textsuperscript{71} Whether or not this strategy would be desirable depends on a number of factors, and, in particular, an analysis of the U.S. UNI rules. If income was accumulated in a foreign trust, and subsequently paid to a U.S. resident or a U.S. citizen, the UNI rules may cause this income to be taxable, even if the distribution was a

\textsuperscript{69} Article XXIX - B paragraph 5.
\textsuperscript{70} Article XXIX – B, paragraph 7
\textsuperscript{71} This result was obtained through not having a Canadian resident beneficiary, and therefore not triggering all of the required conditions for subsection 94(1) to apply. Thus the trust would not be deemed to be Canadian resident. However, if there is a possibility of adding a Canadian resident beneficiary, subsection 248(25) must be considered. This rule provides that where the trust contains a power of addition, persons are deemed to be added as beneficiaries if any of those persons has contributed property to the trust, or is related to such persons.
capital distribution. In addition, an interest factor would be added in accordance with the UNI rules, potentially resulting in more tax than might otherwise be the case if the income was simply earned by the U.S. person in the first place. Note also that under the UNI rules, income does not retain its nature, so the tax on qualifying dividends and long term capital gains could be far more in this situation.

While one might consider setting up a revocable trust, such that it would be considered a foreign grantor trust, this plan has additional obstacles which include:

i) The income would be attributed back to the Canadian resident contributor under an attribution rule, but not from 2013 onwards.\(^{72}\)

ii) A foreign grantor trust would become a foreign non-grantor trust on the death of the grantor, meaning that this is not a foolproof long-term estate plan.

iii) From 2007 and onwards, the non-resident trust would be subject to Canadian tax as a deemed resident trust.\(^{73}\) This would negate the benefit of establishing the trust offshore and retaining income within it from a Canadian income tax perspective. If the income is retained in the trust, it will be taxed by Canada.

iv) Income which is distributed by the trust to U.S. beneficiaries may be subject to withholding tax or a limited deduction in the trust.\(^{74}\)

From a U.S. perspective, an international structure would have two main objectives, the first being reduction, if possible, or at least deferral, of U.S. income tax, and the second being to allow for the accumulation of assets in a trust outside of what would be included in the estate of the U.S. person at death.

There are several ways to avoid the UNI rules. The most basic are to distribute income each year so that no income accumulates in the trust, or to constitute the trust as a U.S. resident trust such that U.S. tax is paid by the trust, and the UNI rules do not apply. Neither of these has a benefit from an income tax perspective. So the only

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\(^{72}\) The attribution rule applies only to a Canadian resident trust from 2013 on.

\(^{73}\) A non-resident trust will be deemed Canadian resident if there is a Canadian resident contributor, regardless of whether there are Canadian resident beneficiaries.

\(^{74}\) Subsection 104(7.01) may limit the deduction.
effective way to avoid the UNI issue and for the U.S. beneficiary to receive funds is with a foreign grantor trust.

From a Canadian perspective, if income is paid out to a U.S. resident beneficiary, it is possible that no or little Canadian tax will be paid by the trust in most circumstances (there are some limitations on the deduction for an income distribution depending on the source of the income). Non-resident withholding tax may be paid at 15% but only if the income is Canadian source due to the special terms of the Canada-U.S. Treaty. Consequently, if the trust has non-Canadian income all of which is distributed to U.S. beneficiaries annually, no Canadian tax will arise.\(^\text{74a}\) So far so good. The additional problem with this approach, however, is that under the non-resident trust rules, the trust will be deemed to sell all of its property at fair market value on the death of the Canadian resident contributor. There is also the 21-year deemed disposition rule to consider. The deemed disposition would not be exempted by the Canada-U.S. treaty, nor would it result in a basis step-up or a creditable tax for U.S. purposes.

This leads to the conclusion that it is difficult to obtain a good tax planning solution in Canada-U.S. planning where a Canadian wishes to benefit U.S. persons. This is especially so where assets will be held long term (such as a family business) and where the assets will appreciate. Consideration should be given as to whether a Canadian resident trust would be a better choice of vehicle than a U.S. trust or a non-resident trust. That way one only needs to consider the 21 year rule.

A benefit could arise from use of a trust for U.S. estate tax. But the capital gain position of the trust needs to be carefully considered, especially if the idea is to carry out some form of an international estate freeze, designed to pass capital gains to the next generation.

Because Canada’s ability to tax a non-resident trust ceases upon the death of the Canadian resident contributor, an opportunity exists to set up a non-resident trust (including a U.S. trust) through a Will (i.e. a testamentary trust) provided it has no Canadian resident beneficiaries (or only successor beneficiaries).\(^\text{75}\) There are a number of ways to do this, but a preferred route would often be to establish a “dry

\(^{74a}\) Article XXII paragraph 2 discussed earlier.

\(^{75}\) See discussion of successor beneficiary earlier, referenced to the applicable definitions in the legislation and specifically subsection 94(1).
trust” which would be a beneficiary under the Will. This trust would be a non-resident trust to which only a nominal contribution was made initially. The idea is to bring the trust into existence while alive, so that it can be funded at the time of death, and then begin to serve its purpose. This is generally preferred to setting up a trust through the Will itself, for various reasons, including practical ones.

The Canada Revenue Agency (CRA) has commented on this matter. Their response casts doubt on whether this plan works, if the estate, as a Canadian resident entity, creates the foreign trust.

A preferred approach might be to set up and fund the foreign trust *inter vivos* but late in life. The foreign trust would then be deemed Canadian resident until death but not thereafter. This matter requires careful consideration.\(^{76}\)

If the U.S. estate tax is repealed, it will be necessary to see what will replace it before concluding on how effective this planning will be.

2. **U.S. Persons Wishing to Benefit Canadian Residents**

The tax planning related to U.S. persons setting up a structure to benefit Canadians is in many ways far more straightforward and rewarding than the reverse situation.

In this case, the tax planning starts with an evaluation of the U.S. issues involved. Because of the U.S. estate and gift tax system, an inter vivos transfer to a trust may give rise to immediate gift tax consequences, subject to the availability of exemptions, unless the transfer is revocable. If the transfer is revocable, then gift tax will arise when the trust becomes irrevocable (generally on the death of the contributor).

For this reason, the trust would either be established in a revocable fashion, or on death, where U.S. estate tax will be paid, and the proceeds after tax can then be utilized.

Of course if the U.S. estate and gift tax is repealed this may make this planning much more interesting.

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\(^{76}\) STEP Canada 2014 CRA Round Table, Question 12, copy available via STEP Canada website www.step.ca
It may also be possible to fund the trust through an insurance policy, although specific U.S. advice will need to be taken in this regard.

Assuming one way or another a trust structure can be established without excessive additional tax this provides a very interesting planning opportunity for the family. If the trust is established in a tax-free jurisdiction, then no tax will be paid on the income of the trust (other than potentially withholding taxes on investment income). Following from this, the income can be retained in the trust and distributed in the following year as capital to the Canadian resident beneficiaries. As discussed earlier, a capital distribution from a non-resident trust is not taxable when received by a Canadian resident person. It is necessary, however, for the receipt of the distribution to be disclosed to the CRA on a prescribed form.77

From a Canadian tax perspective, the trust can remain tax-free indefinitely. This is particularly advantageous, for the following reasons:

- The trust can accumulate income on a tax-free basis over a long period of time, greatly enhancing the overall return because no tax is payable annually.

- The trust is not subject to the deemed disposition rule every 21 years, unless the trust holds taxable Canadian property (primarily direct or indirect interests in Canadian real estate).78

- The trust can distribute capital free of withholding tax, and these funds can be received by Canadian resident beneficiaries free of tax.

- Provided the trust is a discretionary trust, an interest in the trust would have no significant value, and therefore on the death of a beneficiary, no tax consequences arise in Canada.79 Even though the trust interest would be deemed to be disposed of at fair market value at death, this fair market value is arguable nil, resulting in no capital gains tax in Canada.

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77 Disclosure is required on Form T1142, but this is merely for information purposes. That said, the CRA can be expected to follow-up and review the matter, particularly if the distribution is large. The form asks whether the distribution is an income or a capital distribution.

78 The 21 year rule contained in subsection 104(4) does not distinguish between a resident, deemed resident and non-resident trust. However, for a non-resident trust, there is no application of the rule except to taxable Canadian property. This is important to note, however, in dealing with foreign trusts which own Canadian real estate.

79 It is generally accepted by the CRA that the fair market value of an interest in a discretionary trust is nil, since no third party would pay any material amount for the beneficial interest.
This tax planning is often overlooked when U.S. persons carry out estate planning, and very often the beneficiaries receive outright distributions, rather than having a trust arrangement established for them. This leads to foregoing this very lucrative and beneficial tax planning idea.

Any U.S. family wishing to benefit a Canadian resident person, with the sum of say $1 million or more should consider the use of a non-resident trust. Of course, the U.S. estate and gift tax issues must be considered in detail while it remains applicable, and expert U.S. advice must be taken in the first instance.

It should be added that it is possible for the trust to be administered in the U.S. by U.S. trustees, provided the trust document does not provide for submission of matters to a U.S. court. A unique aspect of the U.S. tax system for trusts is that a trust may be administered in the U.S. by U.S. trustees, but not necessarily be U.S. resident. The family may prefer to deal with a trustee close to home, rather than a foreign trustee with whom they are unfamiliar.

3. **Canadian Individuals Moving to the U.S.**

The tax issues for a high net worth Canadian individual moving to the U.S. can be divided into three main categories, which are:

- tax planning in preparation for the move
- tax implications resulting at the move date
- tax issues concerning the structure put in place on an ongoing basis after the move

Each of these issues is considered individually, but in light of the overall objectives, which are, broadly speaking, the following:

- Minimize the tax issues arising in Canada, through various means.
- To the extent that tax results, consider ways to defer payment of the tax.
- Consider the broad issues of double taxation, particularly if the individual will have ongoing Canadian investments or Canadian business interests.
• Consider the U.S. estate and gift tax implications of becoming U.S. resident for estate and gift tax purposes, and the planning which could and should be put in place prior to this time (if still relevant).

• Consider the long-term issues of designing an estate plan, particularly if there will be Canadian resident persons who might benefit.

Central to the tax planning from a Canadian perspective is the departure tax which will apply to accrued capital gains. For this purpose, the assets held by the individual may be divided into certain categories being:

• assets held personally which may be disposed of readily (e.g., portfolio investments)

• assets held personally which will be retained long term

• investments in shares of private corporations, both Canadian and foreign

• investments in partnerships

• investments in retirement plans

• gains in stock options which are unexercised

• investments in Canadian real estate held directly, including a principal residence

• interests held through a Canadian trust.

Each of these types of assets potentially involves its own tax planning strategy.

It is noted that the individual could have assets not listed in these categories, such as a beneficial interest in a foreign or deemed resident trust.

Most fundamentally, the issues which must be considered are the following:

• Is there a way to reduce the value of any of the assets, which would minimize the deemed capital gain on departure?
• Is there a desire to retain certain assets long-term, or can assets be disposed of prior to departure to simplify various issues including departure tax?

• What are the consequences of holding the assets after departure, and what double tax implications could arise?

It will be important to compare Canadian and U.S. tax rates, because only then can a determination be made as to whether recognizing income in Canada prior to the move is more advantageous than deferring the income and recognizing it later.

As mentioned earlier, the departure tax is a deemed realization of capital gains and losses on hand at the time of departure. These capital gains and capital losses are consolidated together, so that one could offset the other. It is therefore necessary to view the matter in its totality, subject to noting certain restrictions on capital losses (for example, a capital loss on personal-use property is deemed to be nil).

Canadian real estate is not deemed to be disposed of on departure, unless a particular election is made for this result to occur. Even if it is deemed to be disposed of on departure, a subsequent capital gain or loss will still be recognized and potentially taxed by Canada. A capital gain will be taxed, while a capital loss may be eligible for a carryback of up to three years against the capital gains previously realized (except if the property is personal-use property in which case the loss is deemed nil).

Particular issues arise with respect to Canadian corporations, which are unique to the Canadian tax system. If a Canadian corporation pays a dividend, tax will be paid in Canada by a Canadian resident shareholder, at the applicable rate. For this purpose, Canadian dividends are divided into three categories, taxable dividends which are eligible, taxable dividends which are ineligible, and capital dividends.

Taxable dividends which are eligible are subject to tax at a lower personal tax rate than taxable dividends which are ineligible. These rates vary considerably by province. But the rate is substantially higher than the capital gains tax rate (e.g. in Ontario 39% on 45% for taxable dividends, 27% for capital gains).

80 Subsection 128.1(4)
81 Subparagraph 40(2)(g)(iii)
82 Subparagraph 128.1(4)(b)(i) and paragraph 128.1(4)(d)
83 Section 89
A capital dividend can be paid out of a Canadian corporation and received by a Canadian resident person free of tax. This capital dividend represents, in very simple terms, the non-taxable portion of capital gains which have been realized. Since capital gains are only 50% taxable, a mechanism exists, via the capital dividend account, to pay out the non-taxable portion through a capital dividend. Since any dividend which is paid will reduce the value of shares of the Canadian corporation, it is always advantageous to pay a capital dividend (if available) prior to departure, to reduce the share value and thus the capital gains tax on departure.

In addition, a Canadian-controlled private corporation earning investment income can obtain a partial refund of corporate tax upon payment of a dividend. The rate of tax refund is set at 38-1/3% of the taxable dividend paid. Because the personal tax rate on the dividend will be approximately the same as or only a little more than the refund given to the corporation, there is no or only a small overall tax cost to paying out a dividend in the circumstances, within the limits of what can be refunded. This strategy would result in lowering the value of the corporation, which then minimizes the departure tax.

Where shares of a Canadian private corporation are subject to the departure tax, because the shareholder has become a non-resident of Canada, double taxation issues can arise in the future. Although the cost base of the shares of the corporation will be revalued to fair market value, this is no longer relevant for Canadian tax purposes, because the person has become a non-resident. Even more significantly, no revaluation is given in the cost of the corporation’s underlying assets, and therefore when they are disposed of, tax will arise on gains in the corporation itself. Because of limitations on a capital loss realized after departure, which generally cannot be carried back to offset the capital gains on departure, double taxation can arise. For this reason, unless it is clear that the shares of the corporation (rather than the underlying assets of the corporation) may be sold at a later date, consideration should be given to liquidating the Canadian corporation prior to departure.

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84 Subsection 83(2)
85 Section 129
The departure tax planning becomes particularly involved in dealing with private Canadian corporations especially if there are retained earnings. The reasons for this are as follows:

1) Upon departure, a capital gain results which will give rise to a revaluation of the cost base of the shares of the corporation for both Canadian and U.S. tax purposes.

2) The retained earnings in the corporation contribute to the value of the shares. Subsequently if a dividend is paid, the value of the shares will be reduced. However, unless the shares are taxable Canadian property, any loss which may subsequently result cannot be carried back against the capital gain.\textsuperscript{86} Even if the property is taxable Canadian property, the capital loss is denied and cannot be claimed if it results from dividend payments due to a special “stop-loss” rule.\textsuperscript{87}

3) Upon taking out a dividend from a Canadian corporation, non-resident withholding tax will apply. This results in double taxation, unless the shares are taxable Canadian property in which case a special credit may be taken for the withholding tax against the tax on the capital gain on departure.\textsuperscript{88} When the system was designed, shares of Canadian private companies were always taxable Canadian property. However, as a result of the change in the definition, shares of a Canadian corporation will only be taxable Canadian property now if their value is derived primarily from Canadian immovable property (real estate and resource properties). This leads to double taxation, once for the capital gains tax, and then again when dividends are withdrawn.

4) Even if the dividends are subject to a reduced rate of withholding (5% being the lowest rate possible), U.S. tax will likely be payable on the dividend, increasing the tax to possibly 20% federally, plus state tax if applicable.

5) For state tax purposes, a foreign tax credit may be denied. Also the step-up in cost-base granted by the Treaty may not be recognized.

\textsuperscript{86} Section 115 restricts capital loss carrybacks to taxable Canadian property
\textsuperscript{87} Subsections 40(3.6) and (3.7)
\textsuperscript{88} Section 119
Certain tax planning steps can be considered which will mitigate the worst aspects of this double tax situation. This planning may include one or more of the following:

- Pay dividends before departure, to reduce the capital gains tax, and minimize any double taxation.

- Consider converting the corporation into a ULC before departure, so that for U.S. purposes, a dividend does not result even though it does for Canadian purposes. 89

- Consider after departure, a transfer of shares to a U.S. subchapter S Corporation, so that a 5% withholding tax applies per the Canada-U.S. Treaty, rather than a 15% withholding tax. Note, however, that as a result of certain “anti-hybrid” rules in the Canada-U.S. Treaty, unless care is taken in how this transaction is done, the reduced treaty withholding tax rate could be denied if a ULC is used. The withholding tax rate on the dividend then would be 25% not 5%. 90

Stock options exercised in Canada produce an employment benefit equal to the difference between the price paid on exercise of the option and the fair market value of the shares at that time. If certain conditions are met, a 50% deduction can be taken from the amount of the benefit, resulting in an effective tax rate of half of what otherwise would be the case. 91 Since the U.S. does not allow such a deduction, and the stock option benefit will be taxed at regular U.S. tax rates (with no relief for any value accrued prior to becoming U.S. resident), it would normally be preferred to exercise such stock options prior to departure. However, other factors could influence this decision, such as whether the stock can be sold immediately or not. If it cannot be sold immediately, and there is the risk that the stock could decrease significantly in value, this could produce a poor tax result. The employment income resulting on exercise cannot be offset by the capital loss from the sale of the stock.

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89 A ULC is an unlimited liability company that is a corporation for Canadian tax purposes and a flow-through entity for U.S. tax purposes.

90 The result of Article IV paragraph 7 of the Canada-U.S. Treaty is to deny treaty benefits to a ULC where the hybrid nature of the entity makes the tax treatment in Canada different to see tax treatment in the U.S. This is the case with a dividend payment but it has been suggested that a stock dividend and reduction of capital may solve this problem.

91 Paragraph 110(1)(d)
4. **U.S. Persons Moving to Canada**

Unlike Canada, the U.S. does not have a departure tax when a person ceases to be resident. The reason for this seems clear. A U.S. citizen or a long-term green card holder still remains subject to U.S. tax, so there is no need for a departure tax. Instead, tax implications arise when the individual gives up U.S. citizenship, or relinquishes a green card after being a long-term green card holder.

Accordingly, the fact that the individual has ceased to live in the U.S. does not have significant consequences from a U.S. tax perspective.

Moreover, the U.S. individual remains liable to the U.S. estate and gift tax regime (as long as it is in force), which stops a person from dissipating assets and avoiding U.S. estate and gift tax, except through planning arrangements which are accepted.

The tax planning on becoming resident in Canada revolves around Canadian issues, rather than U.S. issues, because from a U.S. tax perspective, the situation is tax neutral so to speak (unless the person is neither a U.S. citizen or long-term green card holder).

To determine whether additional planning should be carried out from a Canadian perspective, it is first necessary to evaluate the U.S. tax position of the individual in the context of this planning. For example, if Canadian tax is saved, but merely at the expense of paying U.S. tax, then no benefit results overall, so why should the person bother with a tax planning strategy for Canadian purposes?

The evaluation begins with the comparison of U.S. tax rates to Canadian tax rates, and a “mock up” of what the individual’s tax position will look like once Canadian resident. Of significance is the fact that there will usually be no U.S. tax liability for state and local tax, and so, the tax rate in Canada will likely exceed the U.S. tax rate and perhaps by a lot, making it worthwhile to consider Canadian tax planning steps. Also more deductions are allowed for U.S. purposes including mortgage interest and property tax and the foreign earned income exclusion, if applicable.

By far the largest areas for tax planning will be for investment income and capital gains, real estate holdings and ownership of businesses.
As mentioned earlier in the discussion of Canada’s rules concerning non-resident trusts, a 60-month exemption used to be available through use of a non-resident trust. This was withdrawn in 2014.

The Federal Budget of February 11, 2014 stated that existing trusts would become taxable as of January 1, 2015 unless a contribution was made on or after budget date. If so, the trust would become taxable January 1, 2014.

U.S. persons with U.S. trusts to which they have contributed will find on becoming Canadian resident that these trusts will become deemed Canadian resident from January 1 of that year (i.e., even pre-move). This is a major trap of recent creation. It is also possible that the trust could be deemed resident retroactively for up to five previous years if the trust had Canadian resident beneficiaries and the individual who becomes Canadian resident made a contribution within 60 months thereof.

The other major area of tax planning is in analyzing and determining a strategy for U.S. assets, such as LLCs, U.S. funds, and especially passive income. The Canadian rules are harsh if FAPI arises in these entities and especially a U.S. LLC.

5. **Canadian Residents Owning U.S. Property**

If the U.S. estate tax is repealed, it is likely that this would extend to non-resident aliens. At least that is what one could hope. In which case most of this section may become irrelevant.

Canadian resident persons owning U.S. situs property need to be concerned about U.S. estate tax arising on their death. Many Canadian residents and their professional advisors are unaware of U.S. estate tax rules applicable to non-residents, and believe, incorrectly, that issues only arise with respect to U.S. real estate. They are often surprised to learn that the list of property which is U.S. situs property is quite long, and includes the following:

- U.S. real property
- tangible property located in the U.S. (with a few exceptions)
- shares of U.S. domestic corporations (both private and public)
• options in respect of shares of U.S. domestic corporations (i.e. stock options)

• certain U.S. fixed income investments although most are exempt

Excluded from the list of U.S. situs property are most fixed income investments (where a domestic exemption applies to provide that there is no withholding tax), cash in bank accounts, shares of corporations listed on U.S. stock exchanges but which are not U.S. domestic corporations (i.e. not incorporated as U.S. corporations), and most stock market indexes and such like.

U.S. mutual funds or their underlying assets may well be U.S. situs property, but this depends on exactly how they are constituted. Interests in partnerships and U.S. LLCs which carry on a business in the U.S. or own U.S. real estate may be U.S. situs property.

It is important to note that indirect holdings of U.S. situs property may nevertheless be subject to U.S. estate tax. For example, property held by Canadian resident persons in retirement plans which constitute grantor trusts may result in the property being considered to be owned by the grantor, a Canadian resident individual. This is particularly the case with Canadian Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) and Tax Free Savings Accounts (TFSAs).92

The calculation of the U.S. estate tax for a non-resident alien proceeds in the same manner as it would for a U.S. citizen or resident (for estate and gift tax purposes), with certain modifications. A pro-rated deduction is allowed for indebtedness of the deceased and certain testamentary expenses, based on the ratio of U.S. situs property to the worldwide estate. For example, if 20% of the individual’s worldwide estate is U.S. situs property, then a 20% deduction will be allowed for indebtedness and certain testamentary expenses.

The Canada-U.S. Treaty plays an important role in the U.S. estate tax evaluation. Under the Treaty, particular provisions apply for increasing the exemption limit, and also granting a deferral of when the U.S. estate tax is payable.

92 These plans are defined by specific provisions in the Income Tax Act and are constructed as trust arrangements where the contribution is the beneficiary.
The provisions in the Treaty provide for a pro-rated exemption based on the exemption allowed to U.S. citizens and U.S. resident persons (for 2015 being US$5,430,000). Also, if property is left to a non-U.S. surviving spouse or a trust for the spouse, and other property is left to other beneficiaries, the pro-rated exemption can be claimed twice. It is not clear whether common law partners and same-sex couples are recognized for this purpose under the Treaty.

The federal U.S. estate tax may be claimed as a foreign tax credit in Canada for federal income tax purposes.93 Certain provinces have indicated that this credit will not be permitted at the provincial level, while other provinces appear to not have adopted a position.94

The tax planning for a Canadian resident in regard to U.S. situs property varies considerably based on the nature of the property. There are many issues to balance, which include the following:

- While it may be effective from a U.S. estate tax point of view to hold property through a Canadian or foreign corporation, which would essentially convert the situs of the property to non-U.S., there may be Canadian income tax reasons for not adopting this structure. For U.S. real estate, individual ownership may be preferred for a number of reasons including:
  
  i) the more favourable U.S. income tax rates on capital gains applicable to individuals

  ii) the principal residence exemption on a foreign property, which can only be claimed if the property is held personally

  iii) to avoid the implications of the FAPI rules

  iv) to allow more effective use of foreign tax credits through personal ownership

  v) to avoid a taxable benefit from holding U.S. personal use real estate in a corporation

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93 Article XXIX – paragraph 6 of the Treaty
94 British Columbia has stated that the credit will not be allowed
• Where U.S. situs assets are held in Canadian retirement plans, there may not be other reasonable alternatives for holding the U.S. situs property.

The tax planning which may be considered ranges from very simple techniques, but which may still be effective, to more elaborate structures, which may be costly to put in place and have various undesirable aspects to them. Below is a brief summary of certain of the planning ideas.

1. Sell or gift the property before death.

If the property is sold before death, such that the deceased does not own U.S. situs property at the time of death, no U.S. estate tax will arise. Provided the property is sold bona fide, (or in the case of property which is not U.S. real estate, gifted before death), U.S. situs property is not owned at the time of death, and therefore there is no U.S. estate or gift tax. This planning can be effective and it has the obvious advantage of simplicity.

Where the properties in question are U.S. publicly traded securities, a sale in the marketplace can be considered. Where the property involves shares of U.S. private companies or other U.S. situs property which is not U.S. real estate, a gift which is appropriately documented should be sufficient to avoid the incidence of U.S. estate tax. However, where the property is U.S. real estate, a gift of the property will trigger a liability for U.S. gift tax, for which the Canada-U.S. Treaty will not provide an exemption, nor will the U.S. gift tax be allowed as a foreign tax credit in Canada. Accordingly, on any transfer of real property, it is necessary to make sure that a bona fide sale occurs.

The obvious problem with a strategy of selling or gifting assets shortly before death, is that death cannot always be foreseen. Furthermore, if this strategy is to be used, it will be important to make sure that the individual has given a valid power of attorney for financial matters to someone. There is the risk that a debilitating event could occur, after which the property can only be disposed of through the individual's Will absent a power of attorney.
2. Transfer to a corporation.

Property may be transferred to a Canadian or a foreign corporation. It is important to make sure that this corporation is not a flow through entity for U.S. tax purposes.

In this connection, generally a Canadian corporation is preferred to a foreign corporation, because the use of a Canadian corporation avoids the FAPI rules, is simpler, and allows for the property to be transferred in most circumstances on a tax-free basis for Canadian tax purposes. The use of a foreign corporation will potentially result in the FAPI rules having application, and in most circumstances the property cannot be transferred to the foreign corporation on a tax-free basis. Moreover, there may be no advantage to using a foreign corporation as compared to a Canadian corporation.

It is not clear how the IRS views a Canadian or foreign corporation acting as a “holding company” for owning U.S. investments. One argument is that this corporation is an “alter ego” for the individual, or a sham, and should be ignored. That said, it is very common practice for Canadians to hold investments through Canadian corporations. In a Canadian context, where beneficial ownership of property is held in this way, it has never been suggested that the structure is a sham, or somehow does not pass a substance over form type test. Note however that the structure must provide a rational result in the Canadian context, and holding investments through a Canadian corporation can lead to double taxation because the individual will recognize a capital gain at death, while there is no automatic revaluation in the underlying property held by the corporation. A method must be devised to avoid this double taxation, and there are many possibilities depending on the circumstances.

3. Use a trust.

Properly constructed, a trust may be an effective way of sheltering assets from U.S. estate tax. It has the advantage that for Canadian and U.S. purposes, the trust should be regarded as an individual, benefiting from the lower tax rates applicable to long term capital gains (applicable to an individual and relevant to
U.S. real property sales). Furthermore, this structure may be more advantageous in avoiding double taxation, and providing for foreign tax credit relief. The trust must be carefully constructed to comply with U.S. rules concerning a “retained interest”. For this purpose, U.S. advice must be obtained, and it is wrong to believe that any trust structure which is employed will automatically provide sheltering from U.S. estate tax. The main disadvantage with the trust structure is that property cannot normally be transferred to the trust on a tax-free basis, except in three circumstances (a spousal or common-law partner trust, an alter ego trust, and a joint partner trust). If trusts of this nature are to be used, they must be carefully reviewed from a U.S. estate tax perspective to make sure that the plan will work overall (which is actually far from certain without careful construction of the trust terms).

The other disadvantage with the trust structure is the giving up of ownership and at least some element of control over the assets. The individual may not be prepared to do this.


Family Limited Partnerships are a common way for U.S. persons to reduce the value of their estate, on the basis that the partnership structure is unattractive to a third party buyer. Recently there has been a movement towards using such structures for Canadian planning in the U.S. estate tax context. The planning works by making a retroactive election after death, within 75 days, for the foreign partnership (e.g., a Canadian partnership registered pursuant to a provincial statute) to be designated a foreign corporation, so that, on a retroactive basis, the deceased did not own a partnership interest at the time of death. Instead, the deceased, for U.S. tax purposes, owned an interest in a foreign corporation, which is not U.S. situs property.

There is definite controversy as to whether or not this plan works for U.S. purposes, and it can create a very complex and problematic situation in terms of the ongoing structure. For Canadian tax purposes, the partnership is a flow through entity, but for U.S. tax purposes it is viewed as a foreign corporation. The further implications of this depend very much on what the partnership owned. If
the partnership owned U.S. real estate, there may be numerous adverse consequences, both to the making of the election, and later to unwinding the structure. On the other hand, if the partnership merely owned shares of U.S. corporations, the ongoing implications may be far less problematic.

5. Use of insurance.

Certain families may prefer not to bother with the entire matter of U.S. estate tax, and may simply choose to purchase an insurance policy and forget about the issue. This will be a reasonable approach for persons who are relatively young, and who can buy term insurance cheaply. However, on a long-term basis, and for people who are older or very wealthy, this is a poor solution, when compared to carrying out reasonable tax planning.

In planning for a Canadian family in respect of U.S. estate tax on U.S. situs property, the following steps are suggested as a general methodology:

(1) Perform a comprehensive evaluation of the U.S. situs assets held by the family, noting that assets may be held indirectly, say through retirement plans or trusts which are not protected from U.S. estate tax.

(2) Determine the worldwide estate of the individual concerned.

(3) Determine whether the exemption limits provided under the Canada-U.S. Treaty are enough to eliminate exposure to U.S. estate tax. Note that because these exemption limits are pro-rated, the benefit of these exemption limits may be relatively small for very high net worth families. (It may be possible, however, to enhance the benefit of these exemptions by giving away assets to other family members. This will, however, be a personal choice to be made.)

(4) If a material exposure to U.S. estate tax exists, consider first simple ways to reduce the U.S. situs assets. These might include a sale of U.S. publicly listed securities, or a transfer of them to a Canadian corporation. Other alternatives could include exercise of stock options and a sale of the stock, a sale of U.S. real property etc.

(5) In the event that after taking reasonable steps to divest certain U.S. situs properties, or alter the situs, there is still a material U.S. estate tax liability, consider
whether a foreign tax credit would be available in Canada for the U.S. estate tax. Given that the U.S. estate tax rate is 40%, this will be approximately twice the rate of capital gains tax in Canada (at the top tax bracket). Furthermore, the credit may only be available for the Canadian federal tax and not provincial tax. It is therefore unlikely that this will be a complete solution to the problem.

Certain matters concerning Canadians owning U.S. real estate have been discussed above. The analysis of income tax issues is expanded here.

The first and most important question is how should a Canadian person own U.S. real estate. For this purpose, the following key points should be considered:

- Whether the real estate is used for earning income or held for personal use. If the real estate is held for personal use, then it should be held personally or through a trust and not through a corporation as otherwise a taxable benefit will result. This taxable benefit will likely be based on an imputed value of the real estate as a proxy for rent which is not paid.\(^{95}\)

- If the property is used for earning business income because it is to be developed and sold, then it is perfectly reasonable in the Canadian context for the property to be held in a Canadian corporation. This might be done for many reasons, including limited liability.

- If the property is held through a U.S. corporation, the FAPI rules must be considered, and an evaluation made as to whether the activity constitutes an active business. For this purpose, it may not constitute an active business if there are not at least 6 full-time employees actively engaged in the business throughout the year.\(^{96}\) Even more importantly, the gain on a sale of the real estate will be taxed as regular income for U.S. purposes, and not as a long-term capital gain benefitting from the favourable tax rates applicable to individuals. Accordingly, ownership through a U.S. corporation should generally be avoided unless the real estate activity involves a business of real estate development, where a capital gain would not result in any event on disposal of the real estate.

\(^{95}\) The benefit would be assessed to a shareholder of a Canadian corporation under subsection 15(1). If the shareholder is a non-resident, the payment is subject to non-resident withholding tax.

\(^{96}\) See definition of investment business in subsection 95(1)
If the property is held through a U.S. LLC, an evaluation of the FAPI rules becomes even more important because of the limitation that the U.S. tax paid may not reduce FAPI, leading to significant double tax if the owner of the U.S. LLC is a Canadian corporation.

The tax issues must be balanced against the business issues and legal liability issues involved, which would favour corporate ownership, generally speaking, rather than individual ownership. For example, it may be more difficult to obtain financing in the U.S. where the property is held personally (including through a trust). It would be easier to deal with banking matters if a U.S. entity is used. Also, the issue of liability protection must be considered, particularly given the generally litigious nature of business practice in the U.S.

In most cases, there is no ideal choice of vehicle, and an evaluation must be made between alternatives which will all have certain drawbacks. One possibility may be to use a limited partnership as the ownership vehicle, which will be a flow through entity for both Canadian and U.S. tax purposes, and may offer at least a certain level of limited liability protection. U.S. legal advice should be obtained on how far a limited partnership type structure may extend limited liability. A limited liability limited partnership might be helpful here but recently the Canada Revenue Agency has given a view that these would be regarded as corporations.

Where U.S. real estate is rented, and held through a non-U.S. entity, a 30% withholding tax will be applicable on the gross rental income, unless an election is made for the income to be considered effectively connected with U.S. trade or business, in which case the net rental income will be subject to U.S. tax.

Differences can arise between Canada and the U.S. in the computation of income, and the nature of any gain on sale. Depreciation rates will vary between Canada and the U.S., and in Canada there are restrictions on claiming depreciation which creates or increases a loss in respect of a rental property. In addition, Canada has a more restrictive concept of what constitutes a capital gain, particularly on the sale of real estate. Unlike the U.S., which would normally grant capital gains treatment at a favourable tax rate to an individual where the property is held for at least one year, the Canadian treatment depends on an evaluation of the overall intent concerning the real
estate. Where one of the reasons for the purchase is to sell the property at a profit in the future, the gain may be regarded as business income.97 This determination is made based on a review of all relevant facts, because a taxpayer’s stated intent may be discounted as being self-serving. The facts include:

- the length of time the property was held
- whether or not the property produced income
- frequency of similar transactions
- the taxpayer’s connection to the real estate business, if any
- the financing on the property (if the property is very heavily financed, this is a factor in support of a trading intent)
- the circumstances surrounding the sale such as whether the property was listed for sale
- any improvements done to the property particularly if they amount to redevelopment
- any evidence that the taxpayer’s intent, which may have been development for producing rental income, for example, changed due to unforeseen factors (zoning and/or planning permission for example)
- if the property was used in a business, the circumstances of that use
- any documentation which would objectively speak to intent
- the circumstances of others who also had an investment in the property

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97 This derives from the principle that if the gain is business income it is not a capital gain and business income includes income from an adventure in the nature of trade.
In certain circumstances, there is a very real possibility that for U.S. tax purposes a capital gain results on disposal of real estate, while for Canadian purposes, the gain is viewed as business income.\textsuperscript{98}

Where U.S. real estate is sold by a non-U.S. person, a withholding tax of 10\% of the gross proceeds may be applicable under the so-called Foreign Investment in Real Property Tax Act (or FIRPTA) rules. This tax is a withholding tax, being a down payment on the final tax, and if it exceeds the final tax, as computed on a tax return, the difference will be refunded. That said, there are certain exemptions from the FIRPTA withholding, and a clearance process can be used to reduce the withholding tax to the maximum tax on the gain. This will usually be advantageous, and is commonly done. State withholding may also apply, and certain states also have a clearance certificate type procedure.

6. U.S. Persons Owning Canadian Real Estate

U.S. persons owning Canadian real estate face similar issues to the mirror image situation discussed above.

This is a complex matter, and it should be noted that the Canadian rules are very similar to the U.S. income tax rules, as follows:

- Canada retains the right to tax gains realized from disposal of Canadian real estate by a non-resident, and no treaty exemption is allowed \textsuperscript{99}

- on disposal, a determination must be made as to whether the gain is a capital gain or business income, in accordance with the criteria discussed above

- personal-use real estate should normally be held either directly or through a trust or a foreign corporation, and not through a Canadian corporation, because of the personal benefit which may be imputed. Use of a U.S. LLC or a foreign corporation which elects to be a flow-through entity may be considered, as explained in more detail below.

\textsuperscript{98} Further details may be obtained from many Canadian sources including Taxation of Real Estate in Canada, Michael Cadesky, Editor-in-Chief, Carswell.
\textsuperscript{99} Section 115 and definition of taxable Canadian property
• a withholding tax of 25% will be applied to gross rental income, unless an election is made to report the income on a net basis, in which case the withholding is 25% of the net rental income ¹⁰⁰

• a withholding tax system and clearance certificate procedure applies on the sale of Canadian real estate by a non-resident person, similar to the U.S. system but at 25% of gross proceeds. However, where the gain is business income, or the “recapture” of previously claimed depreciation, the withholding tax rate is 50% rather than 25%.¹⁰¹ A tax return must be filed by the person disposing of the real estate, whereupon the tax for the year will be calculated and the withholding tax will be credited. The tax return must be timely filed, and extensions are not permitted.

• use of a Canadian corporation by a U.S. person will result in subpart F type issues, unless the corporation is a flow through entity for U.S. purposes. Canada has three entities which are considered corporate in nature in Canada, but flow through entities for U.S. purposes. These are unlimited liability companies (ULCs) constituted under the laws of Nova Scotia, Alberta, or British Columbia.

• even if the real estate is held personally, and used as a principal residence, it will not qualify for the principal residence exemption to exempt a gain from tax in Canada. This exemption does not apply to a non-resident.

• ownership through a foreign corporation may result in a lower tax rate than individual ownership or ownership through a trust. The corporate tax rate (25%) is much lower than the top personal tax rate (48% to 54%), but the personal tax brackets for an individual start at a lower rate (around 20% on the first $40,000 of income) and are graduated. If the real estate is used in a business, as inventory or held as an adventure in the nature of trade, branch tax may apply (rate is 5% under the Canada-U.S. Treaty if applicable and 25% otherwise).

• if an inter vivos trust is used, the income and capital gains cannot be paid out to beneficiaries to escape Canadian tax. For a Canadian resident trust, a special tax

¹⁰⁰ Section 212; the election is made under section 216. ¹⁰¹ Section 116
of 36% applies.\textsuperscript{102} For a deemed resident or a non-resident trust, no deduction is given to the trust for the distribution.\textsuperscript{103}

- A trust, Canadian or foreign, inter vivos or testamentary, will be subject to the 21-year deemed disposition rule in respect of Canadian real estate.\textsuperscript{104}

- Deductibility of interest must be considered in light of Canadian rules including thin capitalization (if owned by a Canadian corporation or trust) at a 1.5 to 1 debt to equity limitation.\textsuperscript{105}

7. \textbf{Estate Planning for U.S. Citizens Living in Canada}

The topic of Canadian estate planning could easily fill a book on its own, because such is the complexity of the subject. That said, the most important aspect of the subject from a tax perspective is planning for capital gains. The capital gains which could arise in Canada on death is limited, at most, to an effective tax rate of around 27%.

The U.S. estate tax is based on the value at death, with a tax rate of 40%. The starting point for a U.S. citizen living in Canada is to consider the U.S. estate tax implications first and the Canadian implications second. Put another way, the U.S. implications are much more serious and far-reaching than the Canadian implications. Moreover, the Canadian tax implications at death involve recognition of capital gains, with an adjustment to the basis of assets in the hands of the estate or its beneficiaries, so that taxation at death is basically a timing difference. The U.S. issues result in a permanent payment of the estate tax while also granting a step-up in the basis of the asset.

Canadian estate planning for capital gains will typically involve the following:\textsuperscript{106}

- An estate freeze, typically using a holding company, to limit the value of the individual's estate, and pass on the future growth in value to the next generation, typically through a trust.

\begin{footnotes}
\textsuperscript{102} Part XII.2 tax
\textsuperscript{103} Subsection 104(6) and (7), and subsection 104(7.01)
\textsuperscript{104} Subsection 104(4)
\textsuperscript{105} Subsection 18(4)
\textsuperscript{106} Reference can be made to Taxation at Death, A Practitioner's Guide, Grace Chow and Michael Cadesky, Carswell, especially chapter 18.
\end{footnotes}
• Post-mortem estate planning to eliminate double taxation, which is a major topic unto itself and beyond the scope of this paper.

• Use of insurance, typically held through a Canadian corporation, to provide liquidity and also to reduce the tax at death through certain well established post-mortem estate planning techniques.

For a U.S. citizen, this planning is problematic for the following reasons:

• A Canadian style estate freeze will not be effective from a U.S. perspective.

• The use of the trust as done in the typical Canadian fashion may create a retained interest by the “freezor” making the freeze ineffective from a U.S. estate tax perspective.

• The beneficiaries of the trust may be U.S. citizens as well, creating another layer of U.S. tax considerations and bringing to the forefront the UNI rules.

• Issues may arise in connection with U.S. gift tax.

• The post-mortem estate planning techniques may create a variety of issues from a U.S. perspective. For example, one of the techniques is to pay a capital dividend, which is received tax-free by Canadian resident persons. However, such dividends may be taxable for U.S. purposes.

In addition, since the U.S. estate tax applies potentially to all assets, subject to the applicable exemptions available ($5,434,000 for 2015), other assets become important (e.g., cash) which from a Canadian perspective do not result in tax implications.

The best advice which can be given to a U.S. citizen living in Canada in connection with estate planning is to “plan early, plan often”. The idea of planning early is to have assets accrue in the hands of non-U.S. citizens or trusts which will provide insulation from U.S. estate tax. The idea of planning often is that tax rules in Canada change frequently, and so do U.S. rules. Having to deal with both tax systems at the same time means that change can be expected to be more rapid and the implications more far-reaching. All of this creates significant issues.
It should also be emphasized that while from a Canadian perspective, the use of holding companies and trusts are well understood, and form basic planning structures which are commonly used, from a U.S. perspective, these are foreign entities. Accordingly, considerations arise under the PFIC rules, the subpart F rules, and the UNI rules (the trusts), which make matters very complicated. Without proper advice, the client is left with a “Pandora’s box” of tax problems without good solutions. The higher the net worth of the family, the more complicated and significant the issues are liable to be.

A client could consider using an unlimited liability company (ULC) to act as a holding company. For Canadian tax purposes, this will be viewed as a corporation, but for U.S. purposes, absent an election to designate the entity as a corporation, it will be considered a flow-through entity, like a U.S. LLC. This may at least eliminate the PFIC and subpart F issues.

Most Canadian tax advisors are unaware of the full scope of the U.S. issues that can challenge a Canadian style estate plan for a U.S. citizen. Add to this the fact that large numbers of U.S. citizens living in Canada do not file U.S. tax returns. FATCA seeks to find these people and time will tell if it is successful. U.S. citizens in Canada are giving up in large numbers. Frustrated by the complexities and lack of reasonable solutions, they are renouncing U.S. citizenship. For them, the system has failed them and so they are opting out of it, and who can blame them!

A. This area will undergo major change if President Trump’s tax proposals become law.

But in the face of all of this, President Trump’s tax changes may make a major difference. Here are the implications:

1. Repeal the U.S. estate tax (and hopefully) the gift tax. Replace it with a Canadian style deemed disposition rule with a $10 million exemption on death. This would solve the biggest estate planning obstacles being the onerous U.S. estate tax and the matching of the disposition on death in both countries with income tax.
2. Lower the top U.S. personal rate from 39.6% to 33%, repeal the AMT and the 3.85% net investment income tax. U.S. citizens in Canada will see their U.S. tax drop below the Canadian tax and a foreign tax credit will then normally reduce the U.S. tax to nil absent U.S. source income.

3. Lower the U.S. federal corporate rate to 15%. Since the Canadian corporate tax rate will be over 13.5% (90% of the U.S. rate), sub part F ceases to apply.

If only the filings could be simplified life would be perfect. And as long as these changes stay around forever.

C. **Conclusions**

Canada - U.S. tax planning for individuals is a complex area full of traps which threaten double taxation or worse. But there are planning solutions some of which may be very beneficial. The key to succeeding in this area and avoiding the many pitfalls is to get appropriately qualified professional advice, but it is not easy to find.