[This copy of a chapter of Miller Thomson on Estate Planning is being provided to you, exclusively for your reference. No part of this chapter is to be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, to any person whatsoever. This chapter is subject to copyright by the publisher of Miller Thomson on Estate Planning, Thomson Reuters Canada Limited, and is provided to you subject to the terms outlined on the back of the cover page of the Miller Thomson on Estate Planning publication. No one involved in this chapter is attempting herein to render legal, accounting or other professional advice. If such advice is required, the services of a competent professional should be sought.]

20

U.S. INCOME TAX ISSUES INVOLVED IN CANADIAN TAX AND ESTATE PLANNING

TABLE OF CONTENTS

20.10 U.S. INCOME TAX RULES FOR INDIVIDUALS AND TRUSTS 20-1
20.10.10 Individuals 20-1
20.10.10.10 U.S. Citizens 20-1
20.10.10.20 U.S. Permanent Residents ("Green Card" Holders) 20-1
20.10.10.30 Substantial Presence Test 20-2
20.10.20 Trusts 20-3
20.10.20.10 Grantor Trusts. 20-4
20.10.20.20 Simple Trusts. 20-4
20.10.20.30 Complex Trusts. 20-4
20.10.20.40 Foreign Trusts 20-5
20.10.20.40.10 "Grantor" 20-5
20.10.20.40.20 "Non-Grantor" 20-5
20.20 U.S. ANTI-DEFERRAL RULES 20-7
20.20.10 Corporate 20-7
20.20.10.10 CFC 20-7
20.20.10.20 Passive Foreign Investment Company 20-8
20.20.10.30 Tax Compliance 20-8
20.30 PLANNING SCENARIOS 20-9
20.30.10 Canadian Immigrating into United States 20-9
20.30.20 U.S. Citizen Immigrating into Canada (No Expatriation) 20-10
20.30.30 Estate Planning for Canadian Parents of U.S. Citizen or Resident Children 20-10
20.30.40 Eliminating Accumulations from Existing Foreign Non-Grantor Trusts 20-10
20.30.50 Income Tax and Estate Planning for U.S. Citizens Resident in Canada 20-11
20.40 SUMMARY OF U.S. EXPATRIATION RULES (FOR CANADIAN RESIDENTS OR RETURNING CITIZENS) 20-11

20

U.S. INCOME TAX ISSUES INVOLVED IN CANADIAN TAX AND ESTATE PLANNING

Edward C. Northwood*

20.10 U.S. INCOME TAX RULES FOR INDIVIDUALS AND TRUSTS

20.10.10 Individuals

20.10.10.10 U.S. Citizens

U.S. citizens must report their worldwide income to the U.S., no matter where they reside. U.S. citizens who are Canadian residents for Canadian tax purposes must therefore report their worldwide income to both countries. U.S. domestic tax law combined with the Canada-U.S. Tax Treaty will eliminate actual income tax liability to the U.S. *provided that* there is a total overlap of income inclusion, including that which is included in the individual's income in both jurisdictions in the same year. This rarely occurs where the U.S. foreign corporation or foreign trust anti-deferral rules apply. Moreover, some items of income may be non-taxable in one country but taxable in the other. Canadian capital dividends are a classic example of this. Deductions and tax credits are generally different under both countries' systems as well.

20.10.10.20 U.S. Permanent Residents (''Green Card'' Holders)

Under federal U.S. tax law, non-U.S. citizens holding permanent resident visas also are required to report their worldwide income under exactly the same rules as applied to U.S. citizens. If such an individual is also treated as a Canadian resident for Canadian income tax purposes, the Tax Treaty may be applied to enable that individual to claim for U.S. purposes that he or she is non-resident (and therefore not subject to U.S. tax on his or her worldwide income). But such a position is

* Edited by Edward C. Northwood

clearly inconsistent with holding a permanent residence visa, and it also constitutes an expatriation for tax purposes. As a general matter, an individual who holds a U.S. permanent resident visa and desires to return to Canada should relinquish their visa as of the day he or she resumes Canadian residency.

20.10.10.30 Substantial Presence Test

Individuals who are neither U.S. citizens nor permanent residents may nonetheless be required to report their worldwide income to the U.S. as residents for U.S. income tax purposes under an objective test known as the substantial presence or "Days Test"[1] The test involves a three-year rolling weighted average of days of actual presence in the U.S. Certain days are excluded for these purposes, such as days resident while holding a diplomatic or student visa, or days under special medical circumstances.[2] In all other cases, however, any time in the U.S. at all on particular days counts as one day of residency. The individual is a U.S. resident for a calendar year if the sum of one-sixth of the residence days in the year two years ago, plus one-third of the residence days of the prior year, plus all of the days in the calendar being tested exceed 182 and, in addition, in the calendar year being tested the person has spent 31 or more days present in the year. Thus, you will see that if an individual spends exactly 122 days in the U.S. in three consecutive years he or she will be considered a resident of the U.S. for tax purposes. Accordingly, it is not a six-month issue but rather a four-month issue (although clearly if one spends more than six months in the U.S. in a particular year he or she will exceed the 182-day threshold for that year irrespective of the number of days in prior years.)

There are two important exceptions to the statutory residency test. The first is available to any non-resident alien (that is, non-U.S. citizen) who has a tax home in another jurisdiction, whether or not that country has a bilateral income tax treaty with the U.S. If such an individual has spent less than 183 days in the U.S. in the year in question, has a tax home in another country (basically a centre of vital interest comparison), and such an individual files a Form 8840 on or before June 15 of the following year, then the individual is not considered to be a U.S. resident for U.S. income tax purposes for the year in question.

But if that exception does not apply and the individual does reside in a country with which the U.S. has an income tax treaty (such as Canada), the individual may elect under that treaty to be considered a non-resident of the U.S. provided that the centre of vital interests is in the other country of residency. Because this is a treaty feature, a U.S. tax return must be filed under which the treaty election is made.

Individual states also may impose an income tax and have their own definitions of resident. However, most states define taxable income as that determined for federal income tax purposes, so if a person is not resident in the U.S. for federal income tax purposes, state income may be zero.

---

1 IRC, s. 7701(b).
2 IRC s. 7701(b)(5), (b)(3)(B), (C).

20.10.20 Trusts

All trusts with a U.S. connection must be classified under three separate categories. First, it must be determined whether the trust is U.S. resident or foreign. Second, whether or not the trust is domestic or foreign, it must be determined whether it is a "grantor" trust or "non-grantor" trust. Finally, for purposes of U.S. withholding tax rules and U.S. domestic taxation of U.S. grantors and beneficiaries, a non-grantor trust may be either "simple" or "complex".

There is a two-part "objective" test for determining whether a trust is foreign or domestic for U.S. income tax purposes. The trust satisfying both parts of the test is a domestic trust; failing either or both parts of the test results in the trust being considered a foreign trust. The first part is known as the "court test" which requires that a court within the United States be able to exercise primary supervision over the administration of the trust. Administration for these purposes includes those duties imposed upon a trustee under both the trust instrument and applicable law. The second part of the test, referred to as the control test, is satisfied as long as one or more U.S. fiduciaries have the authority to control, in effect, almost all decisions of the trust.[3] Fiduciaries for these purposes is not limited to trustees but also includes protectors or advisers who, by terms of the trust instrument, have the power to make decisions affecting the trust, such as replacing trustees, consenting to distributions or changing the *situs* of the trust.[4]

A "grantor" trust for U.S. income tax purposes simply refers to trusts under which all of the income earned by the trust is attributed to the settlor of the trust (also known as the grantor, which under U.S. rules is really the contributor to the trust). Grantor trust status may, therefore, only apply during the grantor's lifetime. Examples of trusts that will be treated as grantor trusts, regardless of whether the grantor is a U.S. person or a NRA, include the following:

- A foreign grantor of a revocable trust;[5]
- A foreign grantor of an irrevocable trust that may only benefit a grantor or her or his spouse, or both;[6]
- A U.S. grantor of almost every foreign trust (provided that the foreign trust may benefit a U.S. income taxpayer);[7]
- A U.S. grantor of a revocable trust or an irrevocable trust of which the grantor and/or his or her spouse is a beneficiary;[8] and
- A U.S. grantor of an irrevocable trust over which the individual retains certain administrative powers.[9]

---

3 Delegation of investment management to a non-resident of the U.S., however, does not result in foreign trust status as long as the delegation is revocable. *Treasury Reg.*, s. 301.7701-7(d)(ii)
4 IRC s. 7701(a)(30), (31).
5 IRC s. 672(f)(2)(i).
6 IRC s. 672(f)(2)(ii).
7 IRC s. 679(a)(i).
8 IRC ss. 676, 677, 678.
9 IRC ss. 674, 675.

A simple trust is one that requires that all income be distributed to a specific beneficiary. Thus, for example, a qualified spousal trust would be treated a simple trust. All other non-grantor trusts would be complex trusts. This distinction is only significant for U.S. resident trusts and for foreign trusts that have U.S. source income (where the issue involves U.S. withholding taxes).

The taxation rules for each category of trusts are summarized below.

20.10.20.10 Grantor Trusts

All trust income and expenses and other tax deductions for all purposes is attributed to the grantor. For U.S. domestic estate planning, this is quite advantageous because an individual may settle an irrevocable grantor trust, the value of which would be excluded from his or her estate, and allow the trust to grow tax-free during his or her lifetime. The payment of the income taxes arising out of the income generated by the trust depletes the grantor's estate and yet is not considered a gift for gift tax purposes.[10] As noted below, foreign grantor trust status is generally preferable for foreign individuals planning to benefit U.S. beneficiaries.

20.10.20.20 Simple Trusts

All of the net ordinary income of a simple trust (one which requires the payment of income to a specific beneficiary) results in the trust getting a full deduction for the net ordinary income and the beneficiary including all of such income in his or her income for the year in question, regardless of whether the income is paid.

20.10.20.30 Complex Trusts

U.S. non-grantor, discretionary trusts are taxed on a conduit principle. That is to say, if there are no distributions to beneficiaries, all of the ordinary income (as well as the net realized capital gains) are taxed to the trust. The trust rates are individual income tax rates but they rise much more quickly to the maximum rate. Dividends, however, have a maximum rate of only 23.8 percent under 2015 U.S. federal tax law under the distributable net income rules applicable to U.S. complex trusts, net realized capital gains are seldom treated as having been distributed to the beneficiaries, even where cash distributions exceed the net ordinary income earned by the trust in the same year. Accordingly, capital gains taxes are typically paid at the trust level out of trust corpus.[11] Most interest and rental income, on the other hand, could reach the maximum rate of

---

[10] This trust design is commonly referred to as an "intentionally defective grantor trust", or IDGT, in U.S. tax literature.

[11] Effective January 1, 2013, extensive new U.S. tax legislation known as the *"American Taxpayer Relief Act of 2012"*, hereafter referred to in this chapter as *"The 2013 Tax Act"*, was enacted. Among other changes, the maximum tax rates applicable to qualified dividends (which include those from publicly traded U.S. and Canadian companies and private Canadian corporations other than those classified as passive foreign investment companies, or PFIC's, discussed later in this chapter) and long-term capital gains (gains recognized on capital assets held for more than one year) were raised from 15% to 20%. In addition, for taxable years beginning after December 31, 2012, under new IRC Section 1411 (enacted to help fund the new health care law), an additional tax is imposed on net investment income for individuals, estates or trusts that are U.S. taxpayers. The tax rate is 3.8% and is only incurred where individuals' or fiduciaries' adjusted gross income exceeds a certain threshold amount. For individuals this threshold amount will only apply to high income earners (for

43.4 percent if the net ordinary income exceeds USD $12,300 (2015).[12] As a result, if the trust income is largely income other than qualified dividends, it usually will be distributed to and among the beneficiaries if U.S. income minimization is an objective.

A discretionary trust will be a complex trust for these purposes. Cash distributions, even those labelled as coming solely from capital, will result in the ordinary income being passed through to the beneficiaries in proportion to the distributions that they receive in the year in question. There is also a special rule that allows distributions made within 65 days after the close of a calendar year to be treated as though they were made in the preceding year.[13]

The trustee is responsible for retaining and depositing withholding taxes with respect to any income that is reported out to an NRA beneficiary. Arguably, a distribution of capital in a 65-day period following one calendar year but treated as a distribution in the preceding calendar year for U.S. purposes, would be subject to U.S. tax withholding, but may be excluded from the Canadian beneficiary's income for Canadian tax purposes.

20.10.20.40 Foreign Trusts

20.10.20.40.10 "Grantor"

Under the *Internal Revenue Code, 1986* (hereafter the "IRC"), a foreign grantor trust (FGT) is not recognized as a taxable entity for U.S. tax purposes because the foreign grantor may retain the ownership of the trust assets and income. If the grantor is not a U.S. person[14] for U.S. income tax purposes, he or she is not required to report the trust income to the U.S. tax authority (unless the trust earns U.S. source income).

If the grantor is a U.S. person, any distributions to beneficiaries of an FGT who are U.S. income taxpayers cause no U.S. tax liability to those beneficiaries, but do give rise to reporting obligations described below.

20.10.20.40.20 "Non-Grantor"

Whenever grantor trust status ceases (such as at the death of the grantor), or if a foreign trust does not meet grantor trust criteria, the trust is a foreign non-grantor trust (FNGT). Under the FNGT regime, there are U.S. income tax consequences and additional reporting requirements with respect to any distribution to beneficiaries who are U.S. income taxpayers.

---

example, the threshold for individual U.S. taxpayers, not filing jointly is $200,000 and for married couples who file jointly, the threshold is $250,000).

12 The threshold for estates and trusts is indexed for inflation, and in 2015 it is $12,300. The maximum regular income tax rate is 39.6% in 2015, and thereafter, and the additional medicare tax rate is 3.8%.

13 IRC s. 663(b).

14 Hereafter in this chapter, the term "U.S. person" shall refer to an individual who is either a U.S. citizen or a U.S. domiciliary, as determined for U.S. gift and estate tax purposes.

Each beneficiary of a FNGT is taxed on the trust's current net income[15] to the extent that such income is distributed to the beneficiary pursuant to the governing instrument. The trustee may not avoid the FNGT distribution rules by attempting to label a distribution as coming only from principal. Any distribution in any calendar year to a beneficiary (cumulated for all beneficiaries) is treated as first "carrying out" current income (CI),[16] then accumulated income (that is, CI from prior years that was not distributed, referred to as "UNI" ["undistributed net income"]), and then tax-free trust principal. U.S. law provides that a loan of cash or marketable securities by a foreign trust to a U.S. beneficiary is generally treated as a distribution of the full amount of the loan.

Each U.S. beneficiary must report any distribution received from the FNGT (and from an FGT as well) to the IRS using Form 3520 for each year that a distribution occurs, and must be able to prove the character of the distribution as reported on the Forms 3520 and 1040 (current ordinary income, current capital gain, accumulation distribution, or tax-free principal distributions). The U.S. beneficiary must include in gross income any trust distributions of income, to the extent of his or her share of the FNGT's current income. The U.S. beneficiary will receive a credit for his or her allocable share of the trust's tax payments (or, alternatively, she or he may treat such taxes as a deduction reducing CI).

Should the trust make any distributions in excess of its current income in any year, there is no U.S. tax implication to the extent of the capital portion so distributed, provided that all prior years' net income was fully distributed. To the extent of prior years' undistributed net income (UNI), however, the distribution is treated as a distribution of UNI to a U.S. beneficiary (or proportionately, if more than one beneficiary receives a distribution in such year). Accumulation distributions are treated as ordinary income (that is, the special character of tax-favoured items of income, such as qualified dividends and long-term capital gains, is lost), subject to income tax and interest. The amount of income tax plus compounded interest represents an estimate of the taxes that the beneficiary would have paid if the trust had distributed the UNI as earned. The interest charge is intended to compensate the U.S. government for the delay in payment of the tax.

The trustee of the trust has no obligation to file any U.S. income tax returns or information statements with the IRS. All reporting obligations lie with the U.S. beneficiaries. In order for the U.S. beneficiaries to properly report trust distributions, however, they need information from the trustee for the year in which the distributions are made and, possibly, for prior years as well. Hence, it will be necessary for the trustee to maintain records showing earnings, expenses, and distributions for each year of the trust to assist the U.S. beneficiaries in this regard and provide them a foreign trust "Beneficiary Statement".

---

[15] Current net income means, for these purposes, not only ordinary income (such as interest, dividends, royalties, and rents), reduced by deductible trust expenses, but also net realized capital gains (determined under U.S. rules). IRC s. 643(a) and Treasury Regulations for such section.

[16] Although the author has used the phrase, "current income", or CI, the technical term is "distributable net income", or DNI.

20.20 U.S. ANTI-DEFERRAL RULES

Perhaps the most problematic income tax issue facing U.S. taxpayers who are either resident in Canada or are beneficiaries of a Canadian estate or trust are the so-called anti-deferral regimes. If a U.S. taxpayer is a shareholder of a foreign corporation that generates passive income, then it may be subject to either the controlled foreign corporation (CFC) rules (where U.S. taxpayers own more than 50 percent of the company) or the passive foreign investment company (PFIC) rules, which apply to foreign companies that are primarily holding companies for portfolio and similar passive investments. Both situations are common in Canada-U.S. cross-border situations both to the benefits in Canada of utilizing holding companies, and, under the PFIC rules only, to the ease and frequency of investing in publicly-traded mutual funds.

20.20.10 Corporate

20.20.10.10 CFC

A foreign corporation is a "controlled foreign corporation" (CFC) if "U.S. shareholders" own more than 50 percent of the total combined voting power or more than 50 percent of the total value of the stock in the foreign corporation on any day during the corporation's tax year.[17] For this purpose, "U.S. shareholders" are U.S. income taxpayers owning, directly, indirectly or by attribution, ten percent or more of the total combined voting power of the foreign corporation.[18] Indirect ownership arises, for example, through a U.S. beneficiary's interest in a non-U.S. trust; the trust's ownership is attributed to its beneficiaries, based on facts and circumstances (such as distribution history).[19]

Under the CFC regime, any passive income (such as interest, dividends, rents, where the company does not manage the real property, royalties, capital gains from sales of investments, etc.) is considered "Subpart F" income. Certain U.S. shareholders of a CFC are required to report on a current basis every year their pro rata share of Subpart F income, even if the company does not make a distribution of such income, including by way of dividends in an amount equal to or less than the cumulative total of previously taxed Subpart F income (including that for the year in which dividends are paid) however, whether paid in the current year or a later year, would not be taxable in the U.S., so there is no double U.S. taxation. If actual dividends are paid by the company in the same year, the Canadian taxes on such dividends are available as foreign tax credits against the U.S. income. But if the dividends are not paid in the same year, the foreign tax credit may be lost and double cross-border taxation could occur.

If the share ownership is attributed through a discretionary trust, the U.S. beneficiary could be taxed on phantom income (deemed ordinary dividends) without even getting any cash. There are

---

[17] IRC s. 957(a).

[18] IRC s. 951(b). Ownership for purposes of meeting the threshold test is attributed by way of family relationships, corporations, partnerships, foreign estates and foreign trusts. Thus, for example, if a parent who is a U.S. taxpayer and each of her five U.S. citizen children all owned 8% of a private Canadian company's shares, the company would be a CFC despite the fact that no single individual owned at least 10%.

[19] IRC s. 958(a)(2) and the *Treasury Regulation* interpreting such section.

some equitable rules, that ameliorate the damage. For example, real dividends paid and passed through the trust to the U.S. taxpayer are tax-free up to the amount of previously taxed income.

20.20.10.20 Passive Foreign Investment Company

A foreign corporation is a PFIC if: (1) at least 75 percent of its gross income for the taxable year is passive income, as defined under IRC section 954(c); or, (2) at least 50 percent of the assets held by the corporation during the taxable year produce passive income. Passive income[20] generally includes dividends, interest, royalties, rents, (except where the real property is rented to a related entity or is an actively managed business), annuities, and gain from the sale or exchange of property giving rise to the foregoing types of income.

Under the PFIC regime, unless they make a special election, to treat the PFIC as a Qualifying Electing Fund, or "QEF", with respect to privately-owned investment companies, or to deem there to be an annual sale on a mark-to-mark basis of a publicly-traded PFIC, U.S. shareholders are not taxed on undistributed income of the foreign company. Instead, when a distribution is made or shares are redeemed or sold, the cash received is taxed on a more punitive basis than it otherwise would be, if it constitutes an ''excess distribution''. An excess distribution is: (1) a distribution exceeding 125 percent of the average of the prior three years of distributions; or, (2) a disposition (including a deemed disposition, such as occurs if the company is converted to an unlimited liability company or when a ''QEF'' election is made) of PFIC stock.[21]

The CFC rules override the PFIC rules where U.S. taxpayer ownership began after 1995. Generally, it is preferable for the company to be a CFC as opposed to a PFIC, because of the punitive PFIC excess distribution system.

20.20.10.30 Tax Compliance

The following Forms may be required by a U.S. individual or trust with Canadian or (or other foreign) connections.

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

2. Form 8621 (Return by Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund);[22]

3. Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts);

---

[20] IRC s. 1297(a)(1) and (2).
[21] IRC s. 1291(a)(2), and (b).
[22] IRC Section 1298(f) was enacted in 2010 to require disclosure of PFIC's whether or not cash distributions were made by the PFIC to the taxpayer or the taxpayer disposed of an interest in a PFIC. Under prior rules, no disclosure of such an interest in a PFIC would have been required unless the taxpayer had elected QEF status for the PFIC. As a consequence of this new reporting requirement, now all PFIC's will be required to be disclosed on either a Form 8621 or on a Form 8938.

4. Form 3520-A (Annual Information Return of Foreign Trust with U.S. Owner);
5. Form 8865 (Information Return of U.S. Persons with Respect to Certain Foreign Partnerships);
6. Form 8858 (Information Return of U.S. Persons with Respect to Foreign Disregarded Entities);
7. Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation);
8. Form 8938 (Statement of Foreign Financial Assets); and
9. FinCEN 114 (Foreign Bank Account Report).

20.30 PLANNING SCENARIOS

20.30.10 Canadian Immigrating into United States

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

All interests in trusts should be reviewed to determine if there is any exposure to U.S. income tax that the immigrant would like to avoid. The immigrant could consider moving the *situs* of any such trust to the U.S. to avoid the punitive system that applies to certain foreign trusts. Many of such trusts, however, are likely to be treated as "grantor trusts" as soon as the grantor becomes a U.S. resident. Such trusts should also be reviewed to determine if their value would be included in the immigrant's estate for U.S. estate tax purposes

Before becoming domiciled in the U.S., wealthy Canadians should transfer and restracture some of their asset holdings prior to becoming subject to the U.S. gift and estate tax system. The 2015 exemption from estate taxes for U.S. citizens and U.S. domiciliaries is U.S. $5,430,000, and in 2016 it is U.S. $5,450,000. Therefore, a married couple whose total net worth (including the death benefits on insurance policies that they own and interests in certain trusts) should reallocate ownership between themselves separately and then provide wills that, on the first death, would leave that decedent's estate in trust for the survivor. The wills should utilize terms that would ensure that the value of the trust would not be considered part of the survivor's estate for U.S. estate tax purposes.

Where the pre-immigrant's assets significantly exceed the then-applicable exemption amount (which in 2016 is USD $5,450,000), the easiest step to remove assets from the estate tax base is for one of the immigrants to create an irrevocable trust for the benefit of such immigrant's spouse and other family members prior to moving to the U.S. As with the testamentary trust, this trust agreement can be designed to enable the spouse or other family member to be the trustee as well as

beneficiary but to have the value of the trust excluded from all family members' estates (including that of the settlor and the spouse) upon their deaths.

20.30.20 U.S. Citizen Immigrating into Canada (No Expatriation)

In light of the Canadian repeal of the so-called pre-immigration trust rule that enabled new immigrants to Canada to avoid taxation on certain investment income for up to 5 years, pre immigration planning for U.S. citizens moving to Canada has become less sophisticated. Attention should be given to recognizing certain types of income prior to becoming a Canadian tax resident wherever the tax rate may be less. An example may be the recognition of gains that would be approximately the same amount in Canada because the additional 3.8% Medicare is not creditable in Canada and the basic U.S. tax rate may be lower than that in Canada.

Many U.S. residents own investments in limited liability companies (LLCs). Ownership of LLCs by Canadian residents is problematic under the tax treaty and Canadian domestic law because for U.S. tax purposes, LLCs are either treated as partnerships or disregarded, whereas for Canadian purposes LLCs are foreign companies that are ineligible for treaty relief. Therefore, prior to becoming a Canadian tax resident, interests in LLC's should either be gifted or sold, or restructured, such as converting them to limited partnerships (which conversions are generally non-taxable for U.S. income tax purposes).

20.30.30 Estate Planning for Canadian Parents of U.S. Citizen or Resident Children

A U.S. child of a Canadian parent may keep the value of her or his inheritance, and the growth thereon, outside of his or her estate (that would be subject to U.S. estate tax upon the child's later death) by having the inheritance pass in trust for the child and her or his family. Distributions from such a trust to the child's children also escape the U.S. gift tax regime. If the trust is U.S. resident, income may be accumulated without penalty. If it is Canadian resident, on the other hand, all net income including net realized gains, must be distributed each year to avoid the accumulation penalties. Exhibit 1 (below) compares the distribution and tax consequences of a testamentary Canadian trust and a U.S. irrevocable trust, both of which benefit a U.S. resident.

20.30.40 Eliminating or Avoiding Accumulation Distribution from Existing Foreign Non-Grantor Trusts

Accumulation distributions may be avoided by careful planning. One way to avoid this tax is to make a "stripping distribution" to non-U.S. beneficiaries of the trust, thereby eliminating the trust's UNI. In a subsequent year, distributions can be made to U.S. beneficiaries without incurring throwback tax. Stripping distributions are effective only if the trust does not have separate shares for beneficiaries or groups of beneficiaries. Another way to avoid the tax is to accrue a large amount of fiduciary accounting income in the year a distribution is planned, so that the total distributions do not exceed current income. This can be done by making a distribution in a year an original issue discount bond matures, by surrendering an annuity or insurance contract, or taking a non-liquidating distribution from a partnership or other investment entity.

20.30.50 Income Tax and Estate Planning for U.S. Citizens Resident in Canada

Moving to Canada simply adds tax problems for a U.S. citizen because U.S. citizens must report worldwide income (no matter where they reside) and because they are subject to the U.S. transfer tax system on their gratuitous transfers of all property, wherever situated, during life and on death (no matter where they reside). Upon becoming a Canadian resident for Canadian tax purposes, the U.S. citizen reports worldwide income to two countries. There are, of course, differences in what income is reported and what deductions are available. Nonetheless, there is a considerable overlap of net taxable worldwide income. Both the IRC and the tax treaty provide some relief from double taxation during life.

Two examples of benefits accorded under the IRC to reduce double taxation during life are: (1) the first USD $100,800 (2015) or USD $100,300 (2016) of foreign earned income, as adjusted for inflation, may be elected to be excluded from gross income;[23] and (2) Canadian income tax may be claimed as a foreign tax credit, subject to the complex limitations of the foreign tax credit rules.[24]

Other examples of benefits available under the treaty include the right to defer reporting earnings from Canadian qualified deferred compensation plans. Note, however, that the actual deferral of compensation to such plans does not yield a deduction or exclusion for U.S. income tax purposes. Deferring the earnings in such plans is important, nonetheless, so that the recognition of the income upon ultimate distribution is taxed at the same time to the same taxpayer, thereby enabling the fullest use of the foreign tax credit. It should also be noted that such deferrals need to be elected with respect to U.S. plans, including IRAs, on the Canadian returns of Canadian residents.

20.40 SUMMARY OF U.S. EXPATRIATION RULES (FOR CANADIAN RESIDENTS OR RETURNING CITIZENS)

Since 1995, the U.S. has enacted three different expatriation tax laws, all of which have applied to U.S. citizens who have renounced their citizenship and non-citizens who have resided in the U.S. under a permanent resident visa (commonly referred to as a "green card") for an extended period (such persons are referred to as "long-term residents" under the expatriation tax regime). A subjective rule was replaced on June 4, 2004, with an objective rule that imposed a ten-year clawback regime on both categories of "expatriates" who had certain levels of assets or income. This somewhat bizarre statute was replaced retroactively for expatriations taking place after June 16, 2008. This later law is described below.[25] The critical determination is whether the expatriate (which includes both a renouncing U.S. citizen or a long-term resident who has left the U.S. and returned to Canada to live) is a "covered expatriate", or not. If one is a covered expatriate, he or she is subject to an exit tax and a particularly mean-spirited gift and inheritance tax (imposed on

---

23 IRC, s. 911(a)(1), (b)(2).

24 IRC, s. 27.

25 Generally, IRC, s. 877A and s. 2801 (which applies a gift or estate tax equivalent duty on a U.S. person who receives a gift or bequest from a "covered expatriate).

the recipient, if the recipient is a U.S. person). If one is not a covered expatriate, neither special tax applies.

Long-term permanent residents are subject to the new regime if the permanent resident visa holder lived in the U.S. 8 out of the most recent 15 years immediately prior to the individual's departure from the U.S. The "expatriating act" for such persons is not simply the surrender of his or her green card, but also occurs when he or she first files a Canadian return as a resident and does not waive treaty benefits on his or her U.S. tax return. In other words, as soon as such a person fails to report and pay tax on worldwide income as though he or she was a U.S. resident, there will be a deemed expatriation event for purposes of this tax law.

Covered expatriates are those who meet a certain net worth or average tax liability test (subject to two very important exceptions), or are not in compliance with their U.S. tax obligations. The thresholds are either a net worth (including interests in trusts) at the time of expatriation of US $2 million, or an average U.S. tax liability over the prior five years is USD $160,000 (2015). One is also a covered expatriate, regardless of every other test or exception, if he or she cannot certify, under penalties of perjury, that he or she has complied with all U.S. tax filing obligations for the prior five years (and has actually so complied).

The exceptions to the net worth or average income tests apply to those who were dual citizens of Canada and the U.S. at birth, and either have not lived in the U.S. for more than 10 out of the most recent 15 years, or renounced U.S. citizenship before attaining age 18.5 and had not lived in the U.S. for the preceding ten years.

If one is a covered expatriate, an exit tax is imposed and is payable on April 15 of the year following the year of expatriation. As with the Canadian exit tax, all of the covered expatriate's assets are deemed sold on the date of expatriation, but the first USD $690,000 (2015) of capital gain is exempt from tax. Other taxation rules include: IRAs and RRSPs and similar accounts are deemed included in income as of the date of expatriation; 30 percent withholding tax will apply to distributions from qualified U.S. deferred compensation plans and certain discretionary trusts (including foreign trusts); and, U.S. recipients of gifts and inheritances from such persons are taxed at a flat rate of the highest estate or gift tax rate then applicable, without regard to exemptions.

All initial reporting and disclosure is done on a Form 8854, due at the time the individual's final U.S. citizen/resident income tax return is due.

EXHIBIT 1

COMPARISON OF DISCRETIONARY CANADIAN AND U.S. RESIDENT TRUSTS FOR BENEFIT OF A U.S. RESIDENT

	Canadian Testamentary Trust	U.S. Irrevocable Trust
Canadian Taxation of Trust	On net capital gains; net ordinary income paid to beneficiary subject to Tax withholding at Treaty rates	None (assuming that the "non-resident trust" rules do not apply)
U.S. Taxation of Trust	None	Net capital gains are always taxed at trust level (but no accumulation issues); net ordinary income taxed on a conduit principle (if there are no distributions, trust pays entire tax; later distributions of prior accumulated income are tax-free to beneficiary)
Trustee's U.S. Reporting	None directly, but record-keeping for 3520 Beneficiary Statement requires annual *pro forma* U.S. trust return; prepare Beneficiary Statement for each year distributions are made	Form 1041(calendar year)
U.S. Beneficiary's Taxation	Trust is a FNGT. Therefore, current trust income is reported on flow through basis and accumulations are subject to tax + penalty; Form 3520 (and income reported on 1040)	Only with respect to trust's current ordinary income that is distributed (reported to the Beneficiary on a "Schedule K-1"); no special forms
Trustee's Distribution Constraints	Must avoid accumulations, so all current trust income, including net capital gains, should be distributed. Must avoid investments in non-U.S. mutual funds (PFIC's) and may not create holding companies (CFC's)	None. Income may be accumulated and reinvested without penalty. U.S. Trust would be owner of PFIC or CFC.