Planning for Cross-Border Families: U.S. Tax Issues, Trusts and Reporting and Compliance

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Most of my clients have concerns regarding tax in both Canada and the United States

At Davis LLP since 2008

April 17, 2015: Davis LLP became DLA Piper (Canada) LLP

- Combined with DLA Piper firms worldwide
- Our practice group continues to focus on tax and estate planning for individuals in Western Canada and others, but now we have thousands of new friends
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No one should act upon the comments, examples and information without a thorough examination of the legal/tax situation with their own professional advisors, after the facts of the specific case are considered.
Topics:

1. U.S. Estate Tax and Capital Gains Tax
2. U.S. Beneficiaries and Non-US Trusts and Companies
3. Structures for Canadians to Address U.S. Estate Tax
4. FATCA – Compliance for Canadian Private Trusts
5. Tracking Days Spent in the U.S. and Consequences
1. US Taxpayers and U.S. Tax

- Who are U.S. Persons?
  - U.S. citizens (birthplace, parentage or naturalization)
  - U.S. residents
  - Green card holders

Even when non-residents of the U.S., citizens and green card holders remain subject to U.S. income reporting, capital gains tax and estate tax.
US citizenship by parentage

- Children born to **two** US citizens are US citizens, unless both of the parents was never physically present within the US before the child’s birth.
- Children born to **one** US citizen outside the US may still be a US citizen, if the US parent was in the US for the requisite period before the child was born:
  - Period varies depending on the year of the child’s birth, but if the parent became an adult before leaving the US, children will be US citizens, unless
  - Children born after relinquishment of US citizenship of parent are not US citizens.
Generally, Canada’s transfer taxation is unitary - same tax treatment if you:

- Emigrate
- Sell
- Gift
- Die

Each triggers recognition of capital gains
U.S. Taxes are not unitary

- U.S. taxes each event differently:
  - U.S. expatriation tax, modeled after Canadian emigration tax
  - Sale of property triggers capital gains tax
  - Estate tax on **value** of estate assets, not appreciation
  - Gift tax on **value** of gift; estate tax collected early
U.S. Estate tax - often over-emphasized

- Only applies to estates of U.S. domiciliaries (generally, citizens and green card holders) and owners of U.S. property
- Does not apply on first death, if surviving spouse is a U.S. citizen
- High rate of tax, but only after a large exemption:
  - 40% tax on the value that exceeds US$5.45 million or US$10.9 million per couple (2016 exemption)
- Assets that pass through U.S. estate acquire tax basis of the value at the time of death (but pay no U.S. capital gains tax)
- 99.8% of U.S. taxpayers who died in 2013 paid no estate tax
US Estate tax for Canadians

- Statutory estate tax exemption for non-US taxpayers holding U.S. property is US$60,000
  - This is also the filing threshold for non-US taxpayers
- The Canada-U.S. Tax Convention includes a augmented exemption for Canadian taxpayers that allows an exemption that is the portion of the US taxpayer exemption that the U.S. assets owned by the Canadian bear to his or her total estate
  - Estate is very broadly defined, and detailed reporting is required
  - Canadian who have a total estate less than the US taxpayer exemption (currently US$5.45 million) never have to pay estate tax
- Canadians with complex assets should structure ownership of U.S. assets to limit exposure to both reporting and tax
U.S. Gift Tax

- Applies to all transfers by U.S. domiciliaries unless:
  - Exchange for fair market value
  - Qualified for annual exclusion (US$14,000 per donee or US$148,000, if donee is a non-US spouse)
  - Direct payment of tuition or healthcare to provider
  - Gift tax exemption used (requires filing a gift tax return)
  - Donee is a U.S. charity (including U.S. registered friends of ...)

- Also applies to transfers of U.S. assets by non-US persons
TWO Problems with gifting

1. Even if you jump through all the hoops, the donee receives the property with the donor’s tax cost (for U.S. tax)
   - U.S. spouse or child added as joint owner may owe considerable U.S. capital gains tax on sale after other owners die
2. Canadians have no treaty protection from Gift Tax (40% of the value of the gifted U.S. property)
   - For non-US owners of U.S. property, gifting is almost always the worst option
Capital gains Tax strategy for gifting

- U.S. principal residence exemption is capped at US$250,000 per US taxpayer
  - Bad Plans:
    - Gift transfer of appreciated Canadian property to U.S. taxpayer
    - Gift transfer of appreciated U.S property to anyone other than a U.S. charity
  - Gift transfer of appreciated Canadian property to non-U.S. taxpayer often works well
  - Annual gifting from US spouse to Canadian spouse of interests in Canadian residence can increase flexibility for future sale
  - If US spouse will not need full estate tax exemption on death, it can be used as gift tax exemption to transfer appreciated home
2. US beneficiaries of non-US trusts and companies

- U.S. tax provisions designed to limit the ability of US taxpayers to defer taxes with non-US investment structures
- When combined with U.S. taxation applying to non-residents of the U.S., significant problems arise for:
  - US beneficiaries of non-US trusts
  - US investors in Passive Foreign Investment Companies (PFICs) and Controlled Foreign Corporations (CFCs)
- These issues arise for US citizens who are:
  - beneficiaries of trusts in Canadian Wills,
  - investors in Canadian private companies, and
  - investors in Canadian mutual funds
Trust status for U.S. Tax

- U.S. taxation is less focused on trust residency than Canada

- Key is whether a trust qualifies as a “US Domestic Trust”:
  - US citizen individuals or US institutional trustees control all material decisions, *and*
  - Subject to the primary supervision of a U.S. court

- All other trusts are “foreign trusts”
US Persons with interests in foreign trusts

- Annual information reporting regarding interest in foreign trusts ($10,000 penalty for failure to report)
- Distributions to US taxpayers from trusts that do not qualify as US domestic trusts are generally unfavourably taxed to the US taxpayer:
  - Distributions from current year taxed on same basis as if earned directly
  - Distributions of income or gain realized by the trust that was “earned” by the trust in prior years are taxed as if they were ordinary income received in the year “earned”, plus interest at the IRS rate for late paid tax
Trust distribution of long term capital gain

- A Canadian trust sells a property it acquired 3 years prior for a gain of US$300,000 and distributes the proceeds to a beneficiary who is a US taxpayer.

- For US tax: gain is allocated equally among the 3 years:
  - Year 1: $100,000 is taxed as ordinary income (up to 40%) and subject to interest for two years
  - Year 2: $100,000 is taxed as ordinary income (up to 40%) and subject to interest for one year
  - Year 3: $100,000 is taxed as a capital gain (up to 20%) for current year

- Maximum tax plus interest cannot exceed total distributed amount (but the IRS can take all that is received)!
It gets much worse...

- Grandpa left large Canadian estate:
  - Income to spouse for life;
  - Then income to son for life;
  - All capital distributed to grandchildren immediately on son’s death.

- 50 years later, the son is in his 70’s and his children are working in Silicon Valley

- With no power to distribute capital to the son, any capital gains realized over the past 50 years will be punitively taxed, unless the grandchildren cease to be US taxpayers or disclaim their interest
Alternatives

- US domestic trusts
- Elect to pay US taxes each year (including unrealized gains)
- Foreign grantor trust
- Coordinate distributions
- Careful asset planning and timing
US Domestic Trusts

- Where we know we will have US beneficiaries (especially if there are no other beneficiaries), structuring the trust to be subject to US tax gives more investment flexibility.
- May still be subject to Canadian tax either as factually resident in Canada or deemed resident.
- Some Canadian tax benefits are only available for trusts that are factually resident in Canada (e.g., spousal and principal residence trusts), requiring Canadian-resident US citizen trustees.
- Trusts that are both factually resident in Canada and US domestic trusts may run into foreign tax credit issues, as both countries expect to be the primary tax jurisdiction.
Qualified Electing Fund

- Qualified electing fund election: pay US tax each year as income is earned and capital assets grow
- Election must be made in the first year of the trust
- Generally requires complex dual accounting, due to accounting differences between US and Canada and payment of capital gains as accruing to the US but deferral in Canada
Foreign grantor trust treatment

- If the Canadian trust is an alter ego or joint partner trust it will often qualify as a foreign grantor trust during the lifetime of the person who contributed the assets.

- If the trust continues after the original settlor dies, foreign grantor trust status ends.

- For joint partner trusts, if the funds can be encroached to the surviving spouse a new trust can be settled that will continue to qualify as a foreign grantor trust, but first spouse to die must accept that surviving spouse will have the power to alter the estate plan.
Coordinated distributions

- For trust with both U.S. and non-US beneficiaries that have discretionary distribution provisions, it may be possible to distribute the “bad” income and gain to non-US beneficiaries before any distributions are paid to US beneficiaries.

- US anti-deferral rules have a mechanical method for determining when the “bad” income and gain are distributed.

- Some trusts have little or no income that is not “bad” income (only nominal basis in assets), but distributing first to non-US beneficiaries will usually ease the impact on US beneficiaries.

- Does not work unless a trust has both time and authority to sequence distributions.
Asset selection and timing of trusts

- Avoid realizing capital gains,
- distribute income annually, or
- keep period of trusts short

A trust that will merely hold a simple asset then distribute that asset to the US beneficiary does not raise these problems

- But issues become more challenging if the trust assets include non-US holding companies and other more complex assets
Passive foreign investment companies (PFICs)

- Similar to the anti-deferral regime for foreign trusts, US investors in non-US entities that:
  - At least 75% of income is “passive” income, or
  - At least 50% of the value of the entities assets are earning “passive” income

  any distribution (or proceeds of sale) are taxed as ordinary income and allocated pro-rata to the years in which the investment was held to apply an interest charge (at the IRS late tax payment rate)

- In 2010, most non-US mutual funds were determined to be PFICs

- The anti-deferral provisions apply also to PFIC interests held at death or gifted by US taxpayers, making this regime unavoidable once PFIC interests are held
Canadian estate freeze – Not suited for US taxpayers

- Exchanging appreciated shares that control a Canadian company for fixed value preferred shares and issuing new participating shares to a trust is common Canadian planning.

- Creates significant U.S. tax if the original holders of the controlling shares are US taxpayers.
  - This structure was eliminated in the U.S. by legislation in the 1970’s.
If the original owners of the business are not US taxpayers, but some of the growth beneficiaries (e.g., their children) are, caution is advised:

- Trust will be subject to anti-deferral rules discussed above
- IRS may take the position that the Canadian business becomes a Controlled Foreign Foreign Corporation as a result of indirect and constructive ownership through the trust
Controlled foreign Corporations (CFC)

- A non-US corporation is determined to be a CFC if:
  - US taxpayers own 10% or more of the voting power; and
  - Those US taxpayers collectively own either:
    - More than 50% of the voting power, or
    - More than 50% of the total value of the corporation’s stock
- When considering ownership, the IRS considers direct, indirect and constructive ownership, including an implication that trust beneficiaries own their proportionate share of shares owned by the trust.
- Indirect ownership through discretionary trusts is fraught with uncertainty, particularly if the threshold appears to require at least 10% voting control.
3. STRUCTURES FOR CANADIANS TO ADDRESS US ESTATE TAX

- Canadians (who are not US persons) are only subject to US estate tax with respect to U.S. *situs* property, generally:
  - US real property
  - Tangible property within the US and
  - Securities of US issuers

Not only directly held property, but also property held in many trusts
  - Scope of estate for US estate tax much broader than probate
Implied ownership of trust property

- Two key bases for implied ownership to an individual of trust property:
  - Property was transferred to the trust by the individual and an interest in the trust was retained by the individual
  - Individual has significant control of trust that could cause property to be distributed to the individual
Examples of Canadian trusts that result in US estate tax exposure

- Alter ego and joint partner trusts
- RRSPs and RRIFs
- Trusts formed on an estate freeze
- Many testamentary and *inter vivos* trusts where a trustee is a beneficiary (or related to a beneficiary) and has broad discretionary power
- Many others
RECOMMENDED STRUCTURES to own US Property

- Specially-structured trust to purchase US personal use property where:
  - No individual has contributed property and has any interest in the trust or its assets
  - Trustee powers for distributions are limited or held by trustees who are not related to the beneficiaries
- Interpose a Canadian company as a holding company
  - Works well for investment assets, but poorly for personal use assets because of Canadian tax on **use** of corporate assets by shareholders
4. FATCA, bank accounts and information reporting

- Foreign Accounts Tax Compliance Act was enacted by the US HIRE Act of 2010
- Implemented in Canada pursuant to the 2014 Intergovernmental Agreement
  - Establishes systems for reporting by Canadian financial institutions of information about customers in Canada that may have ties to the US
  - Information flows from Canadian financial institutions to the Canada Revenue Agency, then to the Internal Revenue Service
- FATCA relates to information gathering and disclosure, but does not change US reporting requirements
Burdens of FATCA

- All non-US financial institutions are required to report under FATCA or face stiff tax on any dealings with US parties.
  - To be FATCA compliant each non-US financial institution must confirm that its counter-parties are FATCA compliant.
- All new accounts with Canadian financial institutions are now required to complete forms regarding US status and FATCA compliance.
What qualifies as a foreign financial institution?

- In most countries, whether personal trusts are financial institutions is a question of fact that often requires FATCA reporting
  - Through some tricky definitions in the Canadian regulations, Canadian personal trusts are not financial institutions, but rather are Nonfinancial Foreign Entities (NFFEs)
  - This excludes personal trusts from direct FATCA reporting, but makes the financial institutions they work with (i.e., banks and investment companies) responsible, thus more demanding
- For non-trust investment entities the complex questions still arise and registration for reporting under FATCA may be required
As a NFFE, Canadian personal trusts that are not in the business of managing investments of others are only required to disclose US controlling persons and US beneficiaries to financial institutions with which the trust has dealings.
5. Tracking days spent in the US and potential consequences for Canadians

Pop Quiz:
Which period, if year-after-year you spend this number of days in the U.S., could raise issues in the US?:

- 36 days in each calendar year;
- 123 days in each calendar year;
- More than six months in any 12 month period;
- 183 days in any calendar year?
When counting the days you must include any day in which you were in the US, even for part of the day, unless you went through the US between two other countries on the same day.

Examples:

- You do not count a day if your flight from Vancouver to Mexico City has a stopover in Los Angeles, unless the time in the US includes midnight, in which case you count two days!
- You do count a day in which you enter the US from Canada and return to Canada that same day.
Streamlined Foreign Offshore Procedures

- More than 35 days in the US is enough for the US to deny a Canadian-resident US citizen the more favourable "non-resident" status under the Streamlined Procedures for American taxpayers who are not current on their US tax compliance. Also, having a home available in the US or prior knowledge of the filing obligation will also raise concerns.

- N.b., in January 2016, an IRS deputy commissioner repeated that the Streamlined Procedures is not a permanent program, so we continue to be concerned that non-compliant US citizens should act soon to avoid greater jeopardy.
US statutory rule for tax residency can arise before you spend 183 days in the US in a single year. The US test considers the days spent in the past 3 years:

If the sum of:
- Days in the US this year; plus
- One-third of days in the US last year; plus
- One-sixth of the days in the US from the year before last

is greater than 182 days, you have a filing obligation to the US

123 days each year takes you over the threshold
- If you are under 183 days this year, you should file a Closer Connection statement on form 8840 to avoid additional filings
Prior to June 2014, many Canadians who spent winters in the US did not keep a close eye on the number of days spent in the US, believing that, while the US Immigration and Naturalization Service had records of entry into the US, it did not track exits. While this view was always merely a temptation to an unwise tax strategy, since the implementation of the Canada-US border information sharing treaty in June 2014 there is growing concern that Canadians may be refused entry for exceeding the six months allowed by the U.S.
Mostly American?

- If you spend **more than 182 days** in any calendar year in the US, you likely have more extensive filing obligations. As the Closer Connection statement on form 8840 is not available, you will only have the Canada-US Tax Convention to protect you from reporting and paying tax as a US resident. Even if you tie-break to Canada under the Convention, you will be required to file US foreign bank account reports for all of your bank and investment accounts in Canada (and elsewhere outside the US) and you may have other information reporting required for any interests you hold in non-US corporations and trusts. Hopefully, this news will not make you ill, as you may also be disqualified for BC’s medical services plan.
Questions?

Thank you for listening.

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