Tax Implications of Investing in the United States

RBC Dominion Securities

RBC Dominion Securities Inc.
Financial Planning Publications

At RBC Dominion Securities Inc., we have been helping clients achieve their financial goals since 1901. Today, we are a leading provider of wealth management services, trusted by more than 500,000 clients globally.

Our services are provided through your personal Investment Advisor, who can help you address your various wealth management needs and goals. The Wealth Management Approach includes:

- Accumulating wealth and growing your assets
- Protecting your wealth using insurance or other solutions and managing risk
- Converting your wealth to an income stream
- Transferring wealth to your heirs and creating a legacy

In addition to professional investment advice, RBC Dominion Securities Inc. offers a range of services that address your various tax, estate and financial planning needs. One of these services is an extensive library of educational guides and bulletins covering a wide variety of planning topics. Please ask your Investment Advisor for more information about any of our services.

Please note that insurance products, and, in certain instances, financial planning services, are offered through RBC DS FS Financial Services Inc. Please refer to the back cover for additional information.

Table of contents

1 › Introduction

More and more Canadians are investing in the U.S. in order to diversify their investment portfolio or they are simply purchasing property for their personal use now and in their retirement. Income tax and estate consequences of investing in the U.S. are potentially very complex. The purpose of this publication is to provide a general overview on the principal Canadian and U.S. tax issues associated with such investments.

DOES THIS PUBLICATION APPLY TO YOU?

For the purposes of this publication, the investor is assumed to be a person resident in Canada who is not a U.S. citizen or a U.S. green card holder. For most people, U.S. investments consist of one or more of the following:

- bank deposits;
- U.S. government debt (ranging from Treasury Bills to long-term government bonds);
- U.S. corporate bonds;
- Shares of U.S. corporations; and
- U.S. real estate.

In this publication, we will review the Canadian and U.S. income tax considerations affecting such investments and then we will outline the U.S. Estate Tax concerns associated with them.

Since the U.S. taxation of U.S. citizens living abroad differs dramatically from the U.S. tax regime facing other non-residents, U.S. citizens (and U.S. green card holders) living in Canada should not assume any of the comments in this publication apply to them. In addition, this publication does not attempt to address the personal U.S. state income tax implications of investing in the U.S.

QUALIFIED INTERMEDIARY

Effective January 1, 2001, the U.S. Internal Revenue Service (IRS) implemented changes to its non-resident withholding tax rules by introducing new documentation requirements regarding the U.S. or non-U.S. status of investors. The primary objective of the new rules is to improve the integrity and fairness of the process of claiming reduced rates and exemptions from U.S. non-resident withholding tax for non-U.S. resident investors.

Most non-U.S. financial institutions including the Canadian legal entities within RBC Investments (RBCI) have contracted with the IRS to become a Qualified Intermediary (QI). As a QI, RBCI legal entities can withhold non-resident U.S. tax on U.S. source income received by Canadian residents at preferential rates, provided appropriate personal client documentation is on file. Without appropriate documentation, investors maybe subject to punitive U.S. non-resident withholding tax on income from U.S. securities rather then the reduced rates available through statutory exemptions or tax treaties.

The information in this publication assumes that the investor has provided the necessary personal documentation under the QI requirements to qualify for any applicable exemptions or reduced rates of U.S. non-resident withholding tax.

2 › Implications of various types of investments

BANK ACCOUNTS LOCATED IN THE U.S.

Interest earned in bank accounts located in the U.S. that are not used in a trade or a business conducted in the U.S. is specifically exempt from U.S. non-resident withholding tax. Accounts held at a U.S. bank not actually located in the U.S. are also exempt from this withholding tax requirement.

Even though the interest income earned on U.S. bank accounts is not taxable in the U.S., this interest income is taxable in Canada for residents of Canada. This interest income must be reported annually on the personal income tax return of the account holder because Canadian residents are taxable in Canada on their worldwide income, no matter where in the world the income is earned. As well, the reporting of these amounts must be in Canadian dollars converted at applicable exchange rates.

Interest earned by Canadians on bank accounts located in the U.S. will be reported to the IRS on a U.S. tax reporting slip called Form 1042-S. A copy of this Form 1042-S will be sent to the Canadian recipient of the interest.

›› TAX PLANNING TIP

Interest earned on U.S. located bank accounts is not subject to withholding tax in the U.S. But this interest is taxable in Canada to Canadian residents.

U.S. DOLLAR DENOMINATED BANK ACCOUNTS LOCATED IN CANADA

Interest earned on balances in bank accounts and brokerage accounts located in Canada that are denominated in U.S. dollars are not subject to any U.S. taxes. The interest earned on these accounts is taxable in Canada and must be reported annually on the personal income tax return of the account holder. The reporting of these amounts must be in Canadian dollars converted at applicable exchange rates. Note that even if a T5 tax reporting slip is not received for the interest income because the amount was less than $50, there is still a requirement to report the interest income on the annual tax return.

Please note that when U.S. dollar bank deposits are used to purchase something else, including Canadian dollars, a foreign currency exchange gain or loss may arise. We will discuss this complication in more detail on page 10 of this publication.

U.S. BOND

Government Bonds

The interest income earned on U.S. federal government debt is exempt from U.S. withholding taxes if issued after July 18, 1984. The interest income earned on U.S. state and municipal bonds is also exempt from U.S. withholding taxes.

Even though this income is not taxable in the U.S., the interest income is taxable in Canada on the bond holder's personal income tax return. As well, the Canadian interest accrual reporting rules must be followed for reporting of compound interest income.

Corporate Bonds

Some U.S. corporate bonds on the other hand may be subject to U.S. withholding taxes on the actual amount of interest that is paid out to the bond holder. The applicable rate of withholding tax is a maximum of 10% as prescribed by the Canada-U.S. Income Tax Convention (referred to as the "Treaty", as it is commonly known). The withholding tax is held back and remitted to the IRS, with the balance, usually 90%, being sent to the Canadian resident bondholder. If the bond is held personally with a U.S. paying agent, then the agent will send U.S. tax reporting slip Form 1042-S that will detail the gross amount of interest paid as well as the amount of taxes withheld and remitted to the IRS. If the bond is held in nominee name with a Canadian broker, then the tax reporting information will be contained on a Canadian T5 slip (including the U.S. taxes withheld) and no Form 1042-S will be issued to the bondholder.

When reporting the interest from U.S. corporate bonds on a Canadian tax return, the gross amount of the interest is reportable as income. The amount of taxes withheld in the U.S. (up to 10%) are available to use as a foreign tax credit

TAX PLANNING TIP

Interest earned on many U.S. issued bonds is not subject to U.S. withholding tax. But the interest earned is still subject to the Canadian tax reporting rules for residents of Canada.

in order to reduce Canadian taxes that would otherwise be payable on this U.S. source interest income.

Many U.S. corporate bonds are not subject to U.S. withholding taxes. If the bonds were issued after July 18, 1984, and are in registered form, the interest from these bonds is generally exempt from U.S. withholding taxes. As each bond has different characteristics, the withholding requirement should be carefully investigated before purchase.

SHARES IN U.S. COMPANIES

Dividends

When U.S. corporations pay dividends to shareholders who are resident in Canada, there is a requirement for U.S. taxes to be withheld prior to payment to the Canadian shareholder. The maximum rate of withholding tax is limited by the Treaty to no more than 15% of the gross amount of the dividend. The tax that is withheld is sent to the IRS.

As these dividends are from non-Canadian corporations, these dividends do not receive the preferential Canadian dividend tax treatment that dividends from Canadian corporations would receive. The dividends from U.S. corporations would be taxed in the same way as interest income. That means that the gross amount of the U.S. dividend after it has been converted to Canadian dollars would be taxed at the individual's marginal rate of tax, which is much higher than the tax that would be payable on a comparable dividend from a Canadian corporation, which would benefit from the dividend tax credit. Withholding taxes (up to 15%) after being converted to Canadian dollars would be available as a foreign tax credit that can reduce the amount of Canadian taxes payable on that income.

Capital Gains

Capital gains that result from the sale of U.S. corporation shares are not subject to withholding taxes in the U.S. for most Canadian taxpayers. But, if the individual was resident in the U.S. for a number of years prior to establishing residency in Canada, provisions of the Treaty may make some of the capital gains also taxable in the U.S.

Capital gains or capital losses from the sale of U.S. corporation shares receive the same beneficial tax treatment that the sale of Canadian shares would receive. All capital gains and losses are taxable at a 50% inclusion rate. These gains and losses must be reported on the individual's Canadian personal income tax return. For Canadian tax reporting purposes, the proceeds and Adjusted Cost Base (ACB) for the shares sold must be reported in Canadian dollars using reasonable foreign exchange rates applicable at the time of the buy and sell transactions. In most cases, the ACB of the shares sold must be calculated using a weighted average cost method.

TAX PLANNING TIP

Dividends from U.S. corporations do not receive the favourable taxation treatment that dividends from Canadian corporations receive. As well, U.S. withholding taxes of 15% will be taken. These withholding tax amounts can be used as a foreign tax credit to reduce the Canadian taxes owing on this same income when it is reported on a Canadian tax return.

CORPORATE ACTIONS

Certain types of corporate actions (i.e. takeovers, mergers, spin-offs, etc.) involving the shares in U.S. and other foreign corporations are considered to be non-taxable for Canadian tax purposes. If the corporate action is considered non-taxable, then the total ACB of the original foreign shares "rolls over" to become the total ACB of any new foreign shares received. If the foreign reorganization is considered taxable, the ACB of the newly acquired foreign shares is generally equal to the Fair Market Value of the newly acquired shares.

TAX PLANNING TIP

Every corporate action is unique, the tax implications for Canadian residents should be investigated prior to the event occurring and prior to any action being taken with respect to the security.

Although foreign corporate actions can be structured in many different ways, there are generally three major types of corporate actions that Canadians investing in the U.S., or any other foreign country, should be aware of – foreign takeovers, foreign mergers, and foreign spin-offs. In order to determine the Canadian tax implications of a specific foreign corporate action, it is important to first determine which of these three different types of structures the particular corporate action falls under.

A foreign take-over or acquisition is when one foreign company acquires all of the outstanding shares of another unrelated foreign company and the shareholders of the company being acquired receive shares of the acquiring company and/or cash. A foreign merger is when two or more unrelated foreign corporations combine to form one new foreign corporation and shareholders of each of these original foreign corporations receive shares of the new merged corporation. A foreign spin-off is when a foreign corporation will spin-off a division of its business as a separate company and as a result the shareholders of the original foreign corporation will receive a dividend in the form of these new spin-off shares but also continue to hold their original foreign shares. The Canadian tax implications of these three corporate actions are discussed below in more detail.

Foreign Takeovers

Foreign takeovers will be considered non-taxable to Canadian resident shareholders if only shares of the new acquiring company are received by the shareholder and no cash (other than cash in lieu of fractional shares) is received. However, according to the Canada Revenue Agency (CRA formerly known as Canada Customs & Revenue Agency) if a combination of cash and shares is received on the exchange, a tax-deferred rollover would be available on the share portion (but not the cash portion), provided that the acquiring corporation clearly identifies which portion of shares being acquired will be exchanged for the acquiring company's shares and which portion of the shares being acquired will be exchanged for cash. If this cannot be determined, which is often the case, then the entire transaction will result in a capital gain or capital loss.

Foreign Mergers

Foreign mergers can be structured differently and as a result the Canadian tax implications to Canadian resident shareholders must be investigated on a case by case basis.

However, a typical structure of a foreign merger is when two or more unrelated foreign companies combine to form one new foreign corporation and shareholders of each of these original foreign corporations receive either shares of the new merged corporation and/or cash. If all shareholders receive only shares of the newly merged corporation then the transaction will be considered non-taxable for Canadian tax purposes.

However, if some shareholders opt to receive only shares and other shareholders opt to receive only cash or a combination of cash and shares, then the Canadian tax implications are more complicated.

In this case, the foreign merger will generally be considered fully taxable to those receiving cash or a combination of cash and shares. However, the merger transaction may be considered non-taxable to those Canadian resident shareholders that opt to receive only shares of the new merged foreign corporation if the total cash paid by each original foreign corporation to all of its shareholders is no more than a specified percentage. The calculation of this specified percentage is complex and therefore individuals should consult with a qualified tax advisor in this case.

Foreign Spin-Offs

Occasionally a U.S. corporation will spin-off a division of their business as a separate company and as a result the shareholders of the original U.S. corporation will receive a dividend in the form of these new spin-off shares.

Before the October 18, 2000 Federal Mini-Budget announcements, Canadian tax rules required a Canadian resident shareholder receiving U.S. spin-off shares, in a non-registered account, from their original U.S. shares to report the Fair Market Value (FMV) of the spin-off shares as a foreign source dividend on their tax return. This means that the entire value of the shares received is taxable at the marginal rate of tax of the individual.

The value of this foreign dividend also represented the new Adjusted Cost Base (ACB) of the spin-off shares. The ACB of the original shares did not change as a result of the spin-off. Because of this onerous Canadian tax treatment many Canadian resident shareholders scrambled to dispose of their original U.S. shares before the anticipated spin-off date to avoid the taxable foreign dividend.

As a result of the proposals in the October 18, 2000 Mini-Budget (enacted into law on June 14, 2001), if the spin-off shares were received anytime on or after January 1, 1998 the distribution may now be non-taxable to Canadian resident shareholders if certain criteria are met and if elections by both the shareholder and the original U.S. corporation are filed and accepted by the CRA. Furthermore, the ACB of the original shares before the spin-off will be allocated between the original shares and the new spin-off shares. To draw a comparison, this new tax treatment is similar to how the BCE/Nortel spin-off that occurred in 2000 was treated for Canadian resident shareholders (i.e. non-taxable and the old ACB of BCE was allocated between the new BCE and the new Nortel shares received).

Regardless of these new rules, the FMV of U.S. spin-off shares received in non-registered accounts will continue to be reported as a foreign dividend by Canadian financial institutions on the shareholder's T5 slip. This is understandable since not all U.S. spin-offs will meet the criteria to be considered non-taxable for Canadian tax purposes. Furthermore, it is possible that the relevant elections may not be filed in time by the shareholder or the original U.S. corporation. However, if an individual shareholder (with the assistance of a qualified tax advisor) believes a particular U.S. spin-off meets all the criteria to be considered non-taxable and all required elections are timely filed, and accepted by the CRA, they can exclude the particular foreign dividend from their Canadian income tax return even though it is reported on their T5 slip.

SHARES IN CANADIAN COMPANIES LISTED ON U.S. STOCK EXCHANGES

There are times when an individual will invest in shares of Canadian public companies that are also traded on a U.S. stock exchange. Examples of this are shares of BCE and Barrick Gold, which trade on the Toronto Stock Exchange and the New York Stock Exchange.

Dividends from shares of Canadian public companies traded on a U.S. stock exchange are generally not subject to U.S. non-resident withholding tax. In addition, the dividends from these shares will be eligible for the dividend tax credit on the individual's Canadian income tax return.

SHARES IN AMERICAN DEPOSITORY RECEIPTS (ADRS)

ADRs (also known as ADSs – American Depository Shares or GDRs – Global Depository Receipts) are negotiable certificates issued by a U.S. commercial bank (the "depository") and represent ownership in a stated number of underlying non-U.S. equity securities. Investors can take advantage of investing in a non-U.S. company with, depending upon the type of ADR, similar levels of disclosure as U.S. securities and the convenience of transacting in U.S. markets.

ADRs are registered with the U.S. Securities and Exchange Commission (SEC) and trade freely like any other U.S. security on a national exchange [e.g. NYSE, AMEX, NASDAQ or on the over-the-counter market (pink sheets)]. They are quoted in U.S. dollars, and both dividends and interest (if applicable) are paid in U.S. dollars by the depository.

Tax Considerations

Income earned on ADRs is not considered to be U.S. source income and thus should not be subject to U.S. tax reporting or U.S. withholding tax for non-U.S. persons.

TAX PLANNING TIP

ADR shares within a registered plan such as an RSP or RIF are tax disadvantaged because any withholding taxes on the dividends received cannot be used as a foreign tax credit.

As ADRs generally represent shares of an underlying non Canadian corporation, from a tax perspective, they are considered foreign equities. As ADRs generally represent shares of an underlying non-Canadian corporation, from a tax perspective, they are considered foreign equities. ADR dividends are not eligible for the dividend tax credit.

ADR dividends are also subject to a withholding tax at a rate which should vary with the country in which the company is incorporated. This withholding tax is remitted to the country in which the underlying shares are incorporated.

Investors can claim a foreign tax credit for the amount of foreign tax withheld only if the ADR is held in a taxable account. The tax credit will be limited to the tax normally payable between Canada and the company's country of residence. If the ADR is held within an RSP or other non-taxable account, the investor has no ability to reclaim the tax withheld by the company's home country. As a result, the total income received is the net dividend after withholding tax is removed. Thus, investors who use ADRs in their RSP should consider avoiding high yield ADRs and opt for high capital appreciation ADRs as they have no ability to claim a foreign tax credit on the amount withheld.

ADRs are readily convertible into the underlying ordinary shares (sometimes for a small fee). It is believed that this fact may preclude ADRs from being considered U.S. situs property for U.S. Estate Tax purposes for Canadian residents. U.S. Estate Tax is discussed starting on page 13 of this publication.

CANADIAN BASED MUTUAL FUNDS

When Canadian investors invest in the U.S. through mutual funds based in Canada, the income distributed to investors is reported for income tax purposes on T3 or T5 tax reporting slips. These slips report capital gains realized in the funds and distributed to investors separately from all of the other dividends and interest earned and distributed. Capital gains distributions will be taxable at the favourable 50% rate but all other U.S. source income including U.S. source dividends will be reported as "foreign, non-business income", which would be taxable at the marginal tax rate of the investor.

Any non-resident taxes withheld on dividends and interest earned by the mutual fund will also be flowed out to the investor and these taxes can be used as foreign tax credits to reduce any Canadian taxes payable on this income.

Note that there are potentially punitive U.S. tax implications for U.S. citizens and green card holders living in Canada, holding Canadian based mutual funds or income trusts.

U.S. BASED MUTUAL FUNDS

In general, when distributions are paid from a U.S. based mutual fund to a Canadian resident investor, the fund usually would withhold U.S. non-resident withholding taxes. The rate of U.S. non-resident withholding tax is generally 10% for interest, 15% for dividends. Effective January 1, 2005, U.S. based mutual funds are able to designate dividend distributions as being "interest related dividends" or "short-term capital gains", which allows a Canadian investor to receive such dividends exempt from U.S. non-resident withholding tax. The exemption will not apply where the recipient is a 10% or greater shareholder of the fund. Any taxes that are withheld would be available as a foreign tax credit to reduce Canadian taxes payable on the mutual fund distributions reported on the investor's Canadian personal tax return.

However, when Canadian investors invest in U.S. based mutual funds including U.S. closed end mutual funds which trade on the U.S. stock exchange, the favourable tax treatment of capital gains distributions (i.e. inclusion rate of only 50%) is lost. The income (interest, dividends and capital gains) generated by a U.S. based mutual fund is considered to be completely composed of "foreign income" for Canadian tax purposes and taxable at the marginal tax rate of the investor. Theoretically, this puts U.S. based mutual funds at a tax disadvantage compared to Canadian based mutual funds that would invest in a similar basket of securities.

U.S. REAL ESTATE

Rental Income

If you derived income from a rental property located in the U.S., generally the gross rental income would be subject to a flat 30% U.S. non-resident withholding tax. Of course your net rental income from the U.S. property must be reported on your Canadian income tax return as calculated based on Canadian tax rules. A foreign tax credit can be taken on your Canadian tax return for U.S. taxes paid related to the U.S. rental property, thereby avoiding double taxation.

To avoid being taxed at a flat 30% U.S. withholding tax on the gross rental income, you can file a U.S. non-resident income tax return and elect to be subject to U.S. tax on a net rental income basis (i.e. gross rental income less expenses such as mortgage interest, property taxes, utilities, depreciation, etc.). This choice is made through an election on your original U.S. tax return reporting the net rental income or loss. Due to the rental expenses that are available in determining your net rental income it almost always makes sense to report on a net rental basis. However, once the election is made it applies to all future years in which you have income from the U.S. real estate until revoked. If this election is made, then Form W-8ECI can be completed to avoid the 30% U.S. withholding tax.

Sale of U.S. Real Estate

When you sell U.S. real estate, unless the purchaser is paying not more than $300,000 US and is planning to use the property as a personal residence for themselves, the purchaser is required to withhold 10% under the U.S. Foreign Investment in Real Property Tax Act (FIRPTA) of the purchase price and remit it on your account to the IRS.

If your actual U.S. tax liability is likely to be significantly lower than the statutory withholding, you may apply to the IRS (Form 8288-B) for a withholding certificate to reduce the withholding to an amount approximating the tax liability which would result if the gain, if any, is taxed at the top rate.

> **TAX PLANNING TIP**
>
> Receiving rental income from U.S. real property or selling U.S. real estate will require the filing of a U.S. income tax return. A qualified U.S. tax advisor should be consulted in these situations.

Excess withholding may be recovered by filing your U.S. tax return and claiming the payment as a credit against your U.S. liability for the year.

For U.S. purposes, the ownership of a U.S. vacation property does not require income tax reporting provided it is not also used as a rental property. However any disposition of such a property does require a U.S. tax return filing.

Any gain or loss on the sale of the U.S. property would be taxable in Canada as calculated based on Canadian tax rules. Any U.S. tax paid on the sale could be used as a foreign tax credit to reduce these Canadian taxes payable.

REAL ESTATE INVESTMENT TRUSTS

A Real Estate Investment Trust (REIT) is an entity that manages a portfolio of real estate to earn profits for its owners. REITs function as a collective ownership in real estate, which make investments in a diverse array of real estate, which could include shopping centres, office buildings and hotels. Equity REITs take equity positions in real estate and the REITs' owners receive income from the rents received and receive capital gains as buildings are sold. U.S. REITs generally trade on a U.S. stock exchange.

Canadian residents who receive ordinary dividends from U.S. REITs are normally subject to a 30% withholding tax. However, there is a reduced withholding tax of only 15% under the Treaty if the investor is an individual (including an estate or testamentary trust that acquired the REIT as a consequence of the individual's death, for the five year period following the death) and holds an interest of less

TAX PLANNING TIP

Interest and dividend income from U.S. sources is not subject to withholding taxes if those securities are held by a Canadian registered plan such as an RSP or RIF that is held for the purpose of providing retirement benefits.

than 10% of the trust. Prior to 2005, distributions from a U.S. REIT that were designated as capital gains were subject to a 35% withholding tax. Capital gain distributions made after 2004 won't generally be subject to the 35% rate. Where the REIT stock is regularly traded on a U.S. securities market and the investor owns 5% or less of the REIT stock, the withholding rate will vary from 0% to 30%, depending on the type of investor. Where these conditions are not met, the 35% withholding rate will continue to apply. These withholding taxes can be used as a foreign tax credit on the investor's Canadian tax return in order to prevent the double taxation of the income generated by the investment in the REIT.

Similar to U.S. based mutual funds, any capital gain distributions from U.S. REITs will be taxable as foreign income at marginal tax rates and not be eligible for the 50% capital gain inclusion rate.

LIMITED PARTNERSHIPS

When a Canadian resident makes an investment in a U.S. partnership, this often results in the obligation to file annual non-resident U.S. personal tax returns. The reason for this is that if the partnership is carrying on trade or business effectively connected with the U.S., each non-U.S. partner is treated as if they too carry on a trade or business located in the U.S. This treatment results in the obligation to file a U.S. tax return.

Furthermore, any U.S. source income received during the year that is effectively connected with the U.S. may be subject to non-resident withholding tax equal to the top U.S. marginal tax rate. Any excess U.S. withholding tax may be recovered on the annual non-resident U.S. tax return.

As a Canadian resident, this U.S. limited partnership income must also be reported on the investor's Canadian tax return. However, from a Canadian tax reporting perspective, unless the limited partnership is targeted towards Canadian investors, there may be difficulty obtaining adequate information to properly file a Canadian tax return. The information provided by the U.S. limited partnership, using U.S. Form 1065 (Schedule K-1) for limited partner tax reporting, typically lacks sufficient detail to allow the taxpayer to convert the income from a U.S. tax basis to a Canadian tax basis. With the co-operation of the partnership, these difficulties may be overcome, but will typically increase the complexity and cost of your personal tax return.

To avoid double taxation, foreign tax credits may be taken on the Canadian tax return related to any U.S. income taxes already paid.

INVESTMENTS HELD WITHIN REGISTERED PLANS

Under the Treaty, any interest or dividend income earned from U.S. investments that are held in a trust for the purpose of providing retirement benefits such as RSPs, RIFs, locked-in RSPs, LIRAs, LIFs, LRIFs, or PRIFs will be exempt from U.S. non-resident withholding tax.

Note that any income earned from U.S. investments that are held in a Registered Education Savings Plan (RESP) would not be exempt from U.S. non-resident withholding tax since the purpose of an RESP is to provide education benefits, not retirement benefits.

INVESTMENTS HELD WITHIN CHARITABLE ACCOUNTS

Under the Treaty, U.S. source income derived by a religious, scientific, literary, educational or charitable organization shall be exempt from U.S. withholding tax if this income earned is also exempt from Canadian income tax. Note that adequate proof must be supplied to your advisor that the account meets the above criteria before exemption from U.S. non-resident withholding tax is granted.

3 › Canadian tax reporting

REPORTING OF INVESTMENT INCOME

As previously mentioned, an individual who is considered a resident of Canada based on their facts and circumstances is required to report all income on a Canadian tax return whether that income is from sources inside or outside of Canada.

Any foreign taxes paid on the same foreign income being reported in Canada can be taken as a foreign tax credit in order to avoid double taxation. However, if you paid U.S. tax on income (interest and dividends) from U.S. investments (other than real property) your Canadian foreign tax credit for the income from that property cannot be more than 15% for dividends (10% for interest) from that property.

Net rental income whether from a Canadian or U.S. rental property would be reported on your Canadian tax return. Any U.S. tax paid on net U.S. rental income can be taken as a foreign tax credit in order to reduce your Canadian tax related to this income.

The income tax reporting for any capital gains or losses on the sale of U.S. property (including U.S. real estate) by a Canadian resident investor are identical to the reporting for capital gains or losses on the sale of Canadian property. Therefore, the method of calculating a capital gain or loss related to the sale of any U.S. property (e.g. calculation of ACB) must be done based on Canadian tax rules.

CURRENCY EXCHANGE GAINS

For Canadian tax reporting purposes, the proceeds and ACB for shares denominated in a foreign currency must be reported in Canadian dollars using reasonable foreign exchange rates applicable to the time of the buy and sell transactions. This requirement to use the applicable exchange rate at the time of each buy and sell transaction could result in a capital gain or loss consisting of not only the increase or decrease in the actual price of the investment but also fluctuations in currency since the purchase date.

›› TAX PLANNING TIP

Foreign withholding taxes can normally be claimed on your Canadian tax return to reduce your Canadian tax liability.

The Canadian foreign reporting rules are for information purposes. They do not result in any additional tax liability.

Individuals holding U.S. cash may also incur currency exchange gains or losses at the time of converting the U.S. funds into Canadian dollars, U.S. securities or into another foreign currency.

Note that there is a basic exemption of $200 Cdn on currency gains or losses. Therefore any currency gains or losses $200 Cdn or less would not be reported for Canadian tax purposes. The exemption only applies to currency dispositions not to the foreign exchange part of the gain or loss calculation on the sale of any non-currency asset.

FOREIGN REPORTING REQUIREMENTS

Beginning with the 1998 taxation year, the CRA requires all Canadian residents to report foreign assets if the total cumulative cost of these foreign assets exceeds $100,000 Cdn at any time during the year. These new rules require only the disclosure of information about the ownership of assets located outside of Canada. These rules do not introduce any new taxes.

These foreign assets should be reported on the CRA Form T1135, which is due by April 30 (or June 15 where the taxpayer or spouse is self-employed) of the following year (i.e. the same deadline as a Canadian personal tax return).

The list of foreign property includes the following items:

- Foreign bank accounts
- Property (other than personal use property) located outside of Canada (i.e. rental property)
- Canadian securities held outside of Canada

4 › U.S. BASED RETIREMENT PLANS

- Investments in foreign corporations, foreign trusts, foreign partnerships and in other foreign entities (whether held in an account in Canada or outside Canada, for example, shares of Microsoft held in your Canadian brokerage account need to be reported), and
- Other real, tangible and intangible property situated outside of Canada

Foreign assets which do not have to be reported include:

- Foreign assets held in tax-deferred accounts such as RPPs, RSPs and RIFs
- Units of Canadian mutual funds that invest in foreign securities
- Real property used for personal purposes only (eg. a Florida condominium), and
- Property used exclusively in the course of carrying on an active business

For purposes of the foreign reporting requirements, the value of a foreign property denominated in foreign currency needs to be converted to Canadian dollars at an exchange rate applicable at the time of purchase.

IRAS AND 401(K) PLANS

When an individual works in the United States, they often have the opportunity to invest funds on a tax-deferred basis in a U.S.-based retirement plan. The two most popular U.S. retirement plans are IRAs (Individual Retirement Arrangements) and 401(k) plans (employer sponsored retirement plans). The discussion of IRAs in this section relates to traditional IRAs and not Roth IRAs. Also it is assumed that all the monies in the IRA relate to funds that have not yet been taxed for U.S. tax purposes.

If this individual then establishes or re-establishes residency in Canada, they have several options on what to do with these funds.

If the funds are left in the U.S., then they will grow on a tax-deferred basis for both U.S. and Canadian tax purposes. Any pension amounts eventually paid from the U.S. would be subject to a U.S. non-resident withholding tax of 15% under the Treaty. An IRS Form W-8BEN may need to be filed with the U.S. payer to receive this lower Treaty withholding rate. The gross amount of the U.S. source pension income would be taxable in Canada, and any withholding taxes would be available as a foreign tax credit to reduce Canadian taxes that would be payable on this U.S. retirement income.

CONTRIBUTING IRA AND 401(K) ASSETS TO AN RSP

As an alternative to leaving the funds in the U.S., Canadian tax rules allow a Canadian resident to withdraw the funds from an IRA and contribute these funds into an RSP without affecting regular RSP deduction room provided the IRA assets were derived from contributions made by the individual, their spouse or former spouse. If an individual has a 401(k) plan these funds can be

›› TAX PLANNING TIP

In some circumstances, IRA or 401(k) assets can be contributed to an RSP without affecting your regular RSP deduction room.

withdrawn and contributed to an RSP if the individual was a non-resident of Canada when the 401(k) was earned.

The following is a list of other criteria and issues that one should consider before withdrawing 401(k)/IRA assets for contribution to an RSP. The information below assumes the individual is not a U.S. citizen or green card holder; however, it is still feasible for a U.S. citizen or green card holder residing in Canada to contribute IRA and 401(k) assets into an RSP on a tax-deferred basis.

- As previously, mentioned the 401(k)/IRA assets must be withdrawn while the individual is a resident of Canada.
- As a non-resident of U.S. at the time of the 401(k)/IRA withdrawal, there would be a 30% non-resident U.S. withholding tax. Furthermore, if the individual is less than 59 1/2 years of age at the time of the 401(k)/IRA withdrawal there may be an additional 10% early withdrawal penalty payable. However, the individual should complete IRS Form W-8BEN and give this to the U.S. payer before the withdrawal is made. If this form is completed then the U.S. payor should reduce the U.S. non-resident withholding tax to 15% under the Treaty and possibly allow the individual to avoid the early withdrawal penalty payable to the IRS.
- The gross amount of the withdrawal (before any withholding taxes) would be declared as income on the individual's Canadian income tax return.

If all the above criteria are met, then the individual would be able to contribute the gross amount of this withdrawal into their own non-locked-in RSP (cannot be a spousal RSP or a RIF). The contribution must be made into the RSP by the regular RSP deadline of the year of withdrawal (i.e. year of withdrawal or 60 days after). Please note that if this deadline is missed, this special RSP contribution allowance cannot be carried forward like regular unused RSP deduction room.

- As an illustration, assume there is $100,000 US in the IRA and the U.S. non-resident withholding tax is reduced to 15%. Therefore, there would be $15,000 US non-resident withholding tax remitted to the IRS and the individual would net $85,000 US. The full $100,000 US would be taxable on the individual Canadian income tax return (converted to Canadian currency using an applicable exchange rate) and the individual would be able to contribute the Canadian equivalent of $100,000 US into their own RSP by the deadline. Of course the individual only has netted $85,000 US from the IRA withdrawal, so if they want to maximize this RSP contribution and avoid Canadian taxes they would need to gather the Canadian equivalent of $15,000 US from other sources.
- Assuming the full $100,000 US RSP contribution was made before the deadline, the individual would get an RSP contribution slip of $100,000 US (converted to Canadian currency) which can then be used as a deduction on their Canadian income tax return to offset the $100,000 US income inclusion (assuming currency fluctuations from the time of IRA withdrawal to the time of RSP contribution are nominal).

As previously mentioned, in this case this RSP contribution of $100,000 US does not impact the individual's unused RSP deduction room. Note that any non-Canadian currency amounts contributed to an RSP are automatically converted to Canadian currency inside of an RSP.

- Furthermore, the CRA allows the individual to take a Canadian foreign tax credit for the U.S. non-resident withholding tax. However, this foreign tax credit can only be taken if the individual has adequate other income (including adequate foreign source income) that they are paying tax on in the year of 401(k)/IRA withdrawal and RSP contribution. In this case, the foreign tax credit can reduce the Canadian tax payable on this other income. If they cannot claim the full foreign tax credit since their taxable income is low in the year of 401(k)/IRA withdrawal or they do not have adequate foreign source income, then they will lose this foreign tax credit as it cannot be carried forward or back. If they can claim the full foreign tax credit in Canada then basically the 401(k)/IRA withdrawal and subsequent RSP contribution was accomplished on a fully tax-deferred basis. Please note that if the 10% early withdrawal (less than age 59 1/2) penalty is paid, the CRA has commented that they will not allow a foreign tax credit on this amount.

- If the individual does not have adequate taxable income or foreign source income in one year to claim the full foreign tax credit if a full 401(k)/IRA withdrawal is made, the individual may consider receiving the 401(k)/IRA withdrawal over a period of two or three years for contribution to an RSP. This strategy may allow the individual to claim the full foreign tax credit on their Canadian income tax return over a few years.
- The assets in the 401(k)/IRA could be subject to U.S. Estate Tax (see U.S. Estate Tax section on page 13 for more details) so contributing the 401(k)/IRA assets into an RSP could minimize this U.S. Estate Tax if non-U.S. situs assets are then purchased within the RSP.

As you can see by the above steps, contributing IRA and 401(k) assets into an RSP can get complicated. It is imperative that you consult with a qualified cross border tax advisor before taking any action.

5 › U.S. Estate Tax

INTRODUCTION

The United States has the world's largest equity market. As a result, many individuals currently are invested directly in shares of U.S. corporations. Some individuals have also purchased U.S. real estate for a vacation home or for a source of income as a rental property. At the time of making these purchases, many individuals are unaware of the onerous tax the U.S. government could levy on their estates upon their death because of owning these investments.

This section will only discuss the U.S. Estate Tax on the estate of a U.S. "non-resident alien" (a non-resident and non-citizen and non-green card holder of the U.S.) that owns shares of U.S. corporations, U.S. real estate or certain other property that is deemed to be situated within the United States. For these individuals, U.S. Estate Tax is based on the fair market value of the assets of the estate located or deemed to be located within the United States upon death. This is much different from Canadian "deemed disposition" tax upon death where capital gains tax is only payable on capital property (i.e. stocks, bonds, mutual funds, real estate, etc.) that has appreciated in value. For this reason, even if a U.S.-based asset has lost value since you acquired it, you may still be exposed to U.S. Estate Tax on that asset! Many U.S. states have Estate Taxes as well; however, only federal U.S. Estate Taxes for a Canadian resident who is not a U.S. citizen or U.S. green card holder will be discussed. Various strategies to reduce an individual's exposure to U.S. Estate Tax will also be discussed.

To determine your liability to U.S. Estate Tax, you must identify your U.S. situs (or located) assets. This requires you to determine the total value of all of your assets located or deemed to be located within the United States and subtract any related liabilities (note that the liabilities may have to be prorated based on the ratio of U.S. assets to worldwide assets).

TAX PLANNING TIP

The calculation of U.S. Estate Tax is quite complex. In most cases, professional assistance should be sought.

TAX PLANNING TIP

If the gross value of your worldwide estate is $1,500,000 US or less then there will be no U.S. Estate Tax to pay.

Property located within the U.S. includes the following:

- U.S. real estate
- the assets of a trade or business conducted within the United States
- shares in U.S. corporations whether held in an account in Canada or outside Canada
- bonds, debentures, and other indebtedness of U.S. citizens and residents unless they are specifically exempt tangible property situated within the U.S. (i.e. cars, art, etc.) and U.S. pension plans (including IRAs and 401(k) plans)

As well, discretionary managed accounts where the individual directly owns U.S. situs securities will still be subject to U.S. Estate Tax, even though the buy and sell decisions are not made by the individual owner.

Note: U.S. property held in a Canadian registered plan such as an RSP or RIF must be counted towards determining your total U.S. situs assets for purposes of U.S. Estate Tax unless specifically exempt.

There are some exceptions to the above list that are not considered to be items subject to U.S. Estate Tax. These exceptions include personal U.S. bank deposits (although money in a U.S. brokerage account is not exempt) and some corporate and government bonds subject to the "portfolio interest exemption". Generally, a portfolio interest exemption means that these U.S. obligations were issued after July 18, 1984 and are not subject to U.S. non-resident withholding tax.

CALCULATING THE TAX

Before some recent changes to the Treaty many Canadians holding U.S. situs assets upon their death were subject to substantial U.S. Estate Tax liabilities. However, the changes in the Treaty now reduce or even eliminate the U.S. Estate Tax bill for the estates of many Canadians. In addition, a tax reduction on the deceased's final Canadian income tax return may also be available due to these recent Treaty changes.

Furthermore, due to sweeping U.S. tax law changes enacted in 2001, the previous top U.S. Estate Tax rate of 55% will gradually decrease until 2009 inclusive (see **Figure 3**). The U.S. Estate Tax exemption amounts will gradually increase until 2009 inclusive (see **Figure 2**). There will be no U.S. estate tax for those passing away in 2010. However, without further legislative actions, as strange as it may seem, all U.S. Estate Tax laws in existence before the 2001 tax law changes will be reintroduced after 2010. **Figure 1** lists the marginal U.S. Estate Tax rates in use for 2005.

U.S. ESTATE TAX THRESHOLDS

In order to determine if U.S. Estate Tax is applicable or not, two numbers would be required: the total value (in US$) of U.S. situs assets and the total value (in US$) of worldwide assets (including Canadian and U.S. assets). Note that U.S. situs assets and worldwide assets are determined on a per individual basis not per couple. Furthermore, worldwide assets could also include life insurance death benefits payable after death.

For 2005, Canadians should keep these two thresholds (all in US$) in mind:

$60,000
If an individual's U.S. situs assets are $60,000 US or less on death then there would be no U.S. Estate Tax payable regardless of the value of their worldwide assets.

$1,500,000
a) If an individual's worldwide assets are $1,500,000 US or less on death then there would be no U.S. Estate Tax payable.

b) If an individual's worldwide assets are greater than $1,500,000 US upon death then they could be subject to U.S. Estate Tax on the value of all their U.S. situs assets.

FIGURE 1

U.S. ESTATE TAX RATES FOR 2005 ONLY
(all amounts are expressed in U.S. dollars)

Column A Taxable amount over	**Column B** Taxable amount not over	**Column C** Tax on amount in Column A		**Column D** Rate of Tax on excess over amount in Column A
$ 0	$ 10,000	$ 0	Plus	18%
10,000	20,000	1,800	Plus	20%
20,000	40,000	3,800	Plus	22%
40,000	60,000	8,200	Plus	24%
60,000	80,000	13,000	Plus	26%
80,000	100,000	18,200	Plus	28%
100,000	150,000	23,800	Plus	30%
150,000	250,000	38,800	Plus	32%
250,000	500,000	70,800	Plus	34%
500,000	750,000	155,800	Plus	37%
750,000	1,000,000	248,300	Plus	39%
1,000,000	1,250,000	345,800	Plus	41%
1,250,000	1,500,000	448,300	Plus	43%
1,500,000	2,000,000	555,800	Plus	45%
2,000,000	—	780,800	Plus	47%

The tax rate shown in column D is scheduled to change over the next several years. The rates will not exceed the amount shown in **Figure 3** for the appropriate year.

FIGURE 2

U.S. ESTATE TAX UNIFIED CREDIT
(all amounts are expressed in U.S. dollars)

Year	Exempt Amount	Unified Credit
2005	1,500,000	555,800
2006	2,000,000	780,800
2007	2,000,000	780,800
2008	2,000,000	780,800
2009	3,500,000	1,455,800
2010	tax repealed	not applicable
2011	1,000,000	345,800

FIGURE 3

HIGHEST U.S. ESTATE TAX RATE

Year	Maximum Rate
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%
2010	not applicable
2011	55%

SAMPLE U.S. ESTATE TAX CALCULATION

If a Canadian is subject to U.S. Estate Tax based on the above thresholds, then the amount of U.S. Estate Tax payable can be calculated based on the following steps (a numerical example is used for illustration):

Step One

Determine the total value of U.S. situs assets and worldwide assets upon death in U.S. dollars.

Value of U.S. situs assets:	**$500,000 US**
Value of worldwide assets:	**$4,000,000 US**

Since the value of this Canadian's U.S. situs assets is greater than $60,000 US and their worldwide assets are greater than $1,500,000 US upon death, there could be a U.S. Estate Tax liability.

Step Two

From Figure 1 look up the U.S. Estate Tax payable on the value of the U.S. situs assets. (Note: Do not use the value of the worldwide assets for initially determining the U.S. Estate Tax payable from the table.)

U.S. Estate Tax on $500,000 US from Figure 1:
= $155,800 US

Step Three

Determine the ratio of U.S. situs assets to world-wide assets.

Ratio of U.S. situs assets to worldwide assets.

= $500,000/$4,000,000
= 12.5%

Step Four

From Figure 2 determine the prorated U.S. Estate Tax "Unified" credit available.

There is a non-refundable "Unified" credit of $555,800 US (year 2005 value) available to reduce U.S. Estate Tax. However, for Canadians, this Unified credit must be prorated based on the proportion of the Fair Market Value of U.S. situs assets to worldwide assets. Therefore, multiply the Unified Credit by the ratio calculated in Step Three.

Prorated U.S. Estate Tax Unified credit:

= $555,800 US x 12.5%
= $69,475 US

Step Five

Subtract the prorated Unified credit in Step Four from the U.S. Estate Tax from Step Two.

Net U.S. Estate Tax payable:

= $155,800 US - $69,475 US
= $86,325 US

The Treaty also provides an additional non-refundable marital credit if property is left to a Canadian surviving spouse. This marital credit could potentially give as much relief as the prorated credit calculated in Step Four above because the marital credit will be limited to the lesser of the prorated credit and the U.S. Estate Tax otherwise payable on the qualified property transferred to the spouse. The ability to use this extra credit makes it prudent to provide the executor of the individual's estate some latitude in choosing which assets to transfer to a surviving spouse in order to minimize the U.S. Estate Tax. Therefore, using our example above, the U.S. Estate Tax could be reduced to $16,850 US ($86,325 – $69,475).

Under the Treaty, any U.S. Estate Tax that has to be paid can be claimed on the final Canadian income tax return of the deceased individual using the foreign tax credit mechanism. However, the foreign tax credit cannot exceed the Canadian income tax attributable to the deceased's U.S. source income in the year of death. For this reason, estates that have no accrued capital gains may end up paying U.S. Estate Tax, but receive no offsetting foreign tax credit because there is no tax owing in Canada. The foreign tax credit in effect limits the possibility of double taxation, but it does not limit the possibility of having to pay U.S. Estate Tax.

The U.S. Estate Tax return (Form 706-NA) is only required to be filed to the IRS for those individuals holding at least $60,000 US of U.S. situs assets upon their death. If this threshold is exceeded, your executor or personal representative has the responsibility for filing the appropriate returns whether there is a U.S. Estate Tax payable or not. The U.S. Estate Tax return and any balance owing must be sent to the IRS within nine months of the date of death. An extension to file the U.S. Estate Tax return may be granted, but this extension does not extend the time for the payment of any U.S. Estate Tax liability. There are severe sanctions under the Internal Revenue Code of the U.S. should such a fiduciary knowingly avoid filing these returns. The estate could be subject to significant penalties and the fiduciary could face imprisonment. There are also substantial penalties for understating the value of assets. Accordingly, we recommend that you plan your affairs on the assumption that your executor will file an accurate return, should your estate have a U.S. Estate Tax liability.

STRATEGIES TO MINIMIZE U.S. ESTATE TAX

There are various strategies that can be considered to reduce the exposure that a U.S. non-resident alien may face from U.S. Estate Tax. The strategies outlined below are general in nature and specific circumstances will determine the benefit of one strategy over another. These strategies are of course not an exhaustive list of all the techniques to minimize U.S. Estate Tax; however, the more common strategies are noted.

Gift Assets Prior to Death

For U.S. non-resident aliens, which includes Canadian residents who are not U.S. citizens and not green card holders, there is generally no U.S. gift tax when intangible property such as stocks, bonds and cash are transferred to another individual.

Of course, gifts to anyone other than a spouse are a disposition at market value that would trigger an unrealized capital gain that is taxable in Canada if the asset has appreciated in value.

However, gifting of real estate and other tangible personal property (i.e. automobiles, art, jewelry, etc.) located in the U.S. can trigger U.S. Gift Tax for U.S. non-resident aliens, if the value of the gift exceeds certain minimum amounts. If the total value of all gifts to any individual is $11,000 US or less in a given year, these gifts do not attract Gift Tax. This threshold rises to $117,000 US (to be indexed) if the gift of tangible property is made to a spouse who is not a U.S. citizen. Note that gifts of future interests in property are not eligible for these annual exclusions. This exemption may allow for the “re-balancing” of U.S. situs assets between spouses in order to minimize U.S. Estate Taxes. Note that Gift Taxes may be minimized by using the exemption, and any Canadian taxes on capital gains would be deferred because of the ability to transfer assets to a spouse with no immediate tax implications. However, the Canadian spousal attribution rules would still apply on any investment income generated on the amount gifted to the spouse.

Non-Recourse Financing

If a mortgage was held on U.S. real property at the time of death, then a fraction of the mortgage balance, equal to the ratio of U.S. situs assets to worldwide assets, can be used to reduce the taxable U.S. estate.

However, if non-recourse financing (i.e. a mortgage that is collectable only against a specific property and not against any other assets of the individual) is used for real property (real estate), the taxable value of the U.S. estate is reduced by the full value of the non-recourse financing without requiring the loan to be prorated based on the above fraction.

Non-recourse financing however may be difficult to obtain unless it comes from non-arm’s length persons. This form of financing may be acceptable as long as bona fide arrangements are made concerning the mortgage. These bona fide arrangements include having a market interest rate, reasonable repayment terms and that those terms be specified in writing.

Life Insurance

One of the simplest methods to protect against U.S. Estate Tax is to maintain sufficient life insurance to cover any liability. However, this may be expensive depending on the age and health of the property holder.

For U.S. Estate Tax purposes life insurance proceeds will generally form part of the deceased's worldwide assets for purposes of determining the applicable prorated Unified credit. This rule will serve to decrease the Unified credit available. However, it may be possible to exclude the life insurance proceeds from the worldwide estate calculation by having the policy held in a special irrevocable life insurance trust.

Sell U.S. Situs Assets Prior to Death

This is the easiest and least complicated of solutions; however, it is generally applicable only when the owner becomes seriously ill or just before anticipated death. The reason why this strategy may not be appropriate is that the sale of assets can trigger a tax liability in Canada on the realized capital gain.

Leave assets in a Qualified Domestic Trust ("QDOT")

An unlimited amount of property may be left to a U.S. citizen surviving spouse in order to defer the U.S. Estate Tax until the death of the surviving spouse. This U.S. Estate Tax deferral does not apply if the deceased's spouse is not a U.S. citizen (however, see page 16 for marital credit limits). However, the assets of the deceased could pass free of U.S. Estate Tax to a trust for the benefit of a non-U.S. citizen surviving spouse called a Qualifying Domestic Trust or QDOT. The trust must meet specific criteria in order to qualify for QDOT status; therefore, professional advice is a must.

Joint Ownership of Property

Holding property in Joint Tenancy With Right of Survivorship (JTWROS) with your spouse or another person may result in only a proportionate share of the total value of the property to be part of the deceased's estate for U.S. Estate Tax purposes. However, in order for this strategy to work, it is important to be able to demonstrate that the surviving tenant contributed to the purchase of their own portion of the assets within the JTWROS account with their own funds.

Hold U.S. Situs Assets in a Canadian Holding Company

Just as shares of U.S. companies are defined to be U.S. situs property, shares of non-U.S. companies are defined not to be such property. Accordingly, the shares you hold in a Canadian corporation are not subject to U.S. Estate Tax.

This means that you may use a bona fide Canadian company to hold your U.S. assets and so insulate you from U.S. Estate Taxes. However, for this strategy to work the corporation must be legal and created under relevant corporate laws.

Unfortunately, there is a cost to this. Using a company does involve additional tax filings and financial reporting expenses as well as possible corporate capital tax liabilities.

This strategy can result in the payment of a larger Canadian income tax liability than if the assets were held personally due to the "integration" between the Canadian holding company, and the shareholder. Also the corporate investment income tax rates are now higher than the top personal tax rates.

There are also those who suggest using a Canadian corporation to hold personal use assets such as vacation property. In general terms, this is a very risky strategy because you may be challenged both by the CRA and the IRS for tax purposes. The CRA may assert that the provision of such personal assets by the corporation represents a taxable benefit to you.

However, there is an exception by the CRA, if an individual had set up a Canadian corporation for the sole purpose of holding U.S. vacation property for the use of the shareholder and his family on or before December 31, 2004. However, to take advantage of this administrative concession, one must fall squarely within the rules the CRA has laid down. Note for condominium purchases in the U.S., there are many condominium associations that will not allow ownership by a corporation.

A further complication with this strategy is that the IRS may view that the shareholder is really the owner of the building and not the corporation and therefore may try to impose U.S. Estate Tax on this asset.

Before proceeding with a decision to use a Canadian corporation to hold U.S. situs assets, it is important that the full circumstances of your plan be reviewed by a qualified U.S. tax advisor to determine whether it can achieve the desired objectives.

Hold U.S. Situs Assets in a Canadian Partnership

Although this strategy is complex, there are some experts that suggest holding U.S. situs assets in a Canadian partnership with a family member.

It may be possible to elect to treat the Canadian partnership as a Canadian corporation for U.S. tax purposes thereby potentially avoiding U.S. Estate Tax as mentioned above. However, since the structure would be viewed as a partnership for Canadian tax purposes, some of the negative tax consequences associated with earning investment income inside a Canadian corporation may be avoided.

Due to the complexity and risk associated with this strategy, it is imperative that individuals consult with a qualified tax advisor for more details.

Charitable Donations

When U.S. situs property, on which Estate Tax would otherwise be payable, is bequeathed to a charitable organizations (Canadian or U.S. based) operated exclusively for religious, charitable, scientific, literary or educational purposes, the bequest can be used to reduce the amount of U.S. situs property on which U.S. Estate Taxes are calculated. However, the deceased's Will must contain specific provisions for the donation of these U.S. situs assets.

ALTERNATIVE INVESTMENTS

An alternative to the above suggestions is to purchase investment vehicles with U.S. content that are not subject to U.S. Estate Tax. As with all investment decisions, the investment merits of specific securities should be considered with your advisor in light of your investment objectives and your investor profile.

The following are some examples of alternative investments:

- Shares of Canadian mutual fund corporations that invest in the U.S. market
- Units of Canadian mutual fund trusts that invest in the U.S. market are also likely exempt from U.S. Estate Tax. However, tax experts have had varying opinions on these particular investments. Therefore, individuals who are concerned should consult with a qualified tax advisor for a professional opinion.
- American Depository Receipts (ADRs) are also exempt from U.S. Estate Tax since the underlying share is of a non-U.S. corporation.
- U.S. bank deposits
- U.S. corporate and government bonds subject to the portfolio interest exemption
- Canadian issuer U.S. pay bonds–provides exposure to U.S. dollar

6 › Conclusion

Planning for U.S. Estate Taxes and recognizing the connection between the Canadian and U.S. income taxes is very complex. The importance of taking one's individual circumstances into account cannot be overemphasized.

It is essential that individuals considering altering their estate plans consult with qualified tax advisors before actually undertaking any of the alternatives.

This publication is only intended as a general reference. Individuals should consult with a professional advisor familiar with both Canadian and U.S. personal income tax issues before taking any action based upon information contained in this publication.

Please consider revisiting your plans periodically, since individual circumstances and relevant tax laws do change over time.

This document has been prepared based on the tax law in effect as of the date of publication.

Notes

For more information, speak with an Investment Advisor
from RBC Dominion Securities Inc.

Visit our website: **www.rbcds.com**

USTAX (10/2005)