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U.S. Expatriation and Other Cross-Border Planning Tools

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U.S. EXPATRIATION AND OTHER CROSS-BORDER PLANNING TOOLS

I. Introduction: The U.S. *Tax Cuts and Jobs Act*

The tax rules that apply to U.S. citizens, both during their lives and on death, often become confusing and limiting when applied to a U.S. citizen living in Canada. The complexity of these rules was recently compounded on December 22, 2017 when the most significant U.S. tax reform legislation since 1986 was signed into law by President Donald Trump, commonly referred to as the *Tax Cuts and Jobs Act* (the "**TCJA**"). While many provisions of the TCJA have made tax planning for U.S. citizens in Canada more mired in difficulty and rules, the changes made by the TCJA to the U.S. transfer tax provisions enhanced certain planning options for U.S. citizens living in Canada that were previously restricted.

The goal of this paper is to first provide a brief overview of the U.S. transfer tax rules and how the TCJA amended them. Second this paper will highlight several planning opportunities that are now available to more U.S. citizens living in Canada given amendments by the TCJA to the U.S. transfer tax rules.

The changes made by the TCJA to U.S. transfer taxes, as set out below, are temporary and, unless there are further amendments to this portion of the TCJA, will only apply through the 2025 tax year. It is impossible at this time to predict what will happen at the end of 2025, or even in the intervening years, and therefore if the planning set out below would be beneficial for your clients, advice should be sought promptly and periodically.

II. The U.S. Transfer Tax Rules, Before and After

The United States imposes a tax on a U.S. citizen or U.S. domiciliary[1] when he or she transfers an interest in property, regardless of where such individual resides and regardless of where the interest being transferred is located. If the transfer is made by the person during his or her lifetime, it is taxed under the U.S. gift tax rules. If the transfer is made by the person as a result of his or her death, it is taxed under the U.S. estate tax rules. In addition, an additional tax is imposed both on lifetime or testamentary transfers of property that are considered to have skipped a generation such as from a grandparent to a grandchild under the generation-skipping transfer tax rules. Each of these is discussed in turn below and includes discussion on both the rules prior to the TCJA and now after this recent tax reform.

A. U.S. Gift Tax

The U.S. federal gift tax is imposed on the donor at the time the gift is completed.[2] It applies to gifts that are direct or indirect, outright or in trust. The value of the gift is determined as of the date the gift completes. However, each U.S. citizen or U.S. domiciliary is entitled to exempt *cumulatively* from U.S. gift tax a certain amount, referred to generally as the "lifetime exemption" for lifetime gifts.

For the 2017 tax year, prior to the TCJA and as a result of the *American Taxpayer Relief Act of 2012* (the "**2012 *Tax Act*"**), the lifetime exemption was $5,000,000[3], adjusted for inflation from the 2011 tax year

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1 The test for application of the U.S. estate tax for a non-citizen depends on whether the individual is "domiciled" in the U.S. at the time of death rather than merely a "resident" of the United States. In short, the U.S. Treasury Regulations provide that a person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

2 Treas. Reg. s. 25.2511-2(b).

3 All dollar amounts in U.S. currency, unless otherwise specified.

to $5,490,000, with a top gift tax rate of 40%. For 2018, as a result of TCJA, the lifetime exemption has been doubled to $10,000,000, adjusted for inflation from the 2011 tax year in 2018 to $11,180,000. This is legislated to be adjusted for inflation going forward. However, in 2026 the lifetime exemption is set to return to the 2011 tax year amount of $5,000,000, as adjusted for inflation.

Although the analysis is outside of the scope of this paper, in addition to the lifetime exemption, there are certain annual exclusion amounts permitted,[4] unlimited gift tax exclusions for funds paid on behalf of an individual for certain educational and medical expenses,[5] certain charitable deductions, and an unlimited deduction for transfers of property to the donor's spouse if the parties are legally married and the donee is a U.S. citizen.[6]

B. U.S. Estate Tax

The U.S. federal estate tax is imposed on a decedent's estate in respect of all of the decedent's assets owned at death. In addition, included in a decedent's estate are interests in certain assets that otherwise may appear to have been relinquished prior to death, or to have no value.[7] The value of a decedent's estate is determined at the date of his or her death,[8] provided that an executor can elect to use an alternate valuation date six months after the decedent's death.[9]

Similar to the U.S. gift tax and the lifetime exemption for lifetime gifts, each U.S. citizen or U.S. domiciliary is entitled to exempt an exemption on death in respect of the assets that form his or her "gross estate" and that would otherwise all be subject to U.S. estate tax. The available exemption on death is aligned with the lifetime exemption. Thus, as of the 2017 calendar year the exemption was $5,000,000, adjusted for inflation to $5,490,000, and then as a result of the TCJA was doubled in the 2018 calendar year to $10,000,000, adjusted for inflation to $11,180,000. The top marginal U.S. estate

4 $100,000 per year to a non-U.S. citizen spouse, adjusted for inflation in the 2018 calendar year to $152,000, and $10,000 per year to any one *other* than a non-U.S. citizen spouse, adjusted for inflation in the 2018 calendar year to $15,000.

5 IRC section 2503(e).

6 IRC section 2523(a).

7 For example, see IRC sections 2036 through 2043 and section 2045.

8 IRC section 2031.

9 IRC section 2032.

tax rate remains is 40%. In the tax years prior to 2011 the estate and gift exemptions were not aligned and differed in amount.

However, even when the exemptions varied as between them, the estate and gift tax exemptions have and continue to work as essentially one exemption, with any portion of an individual's lifetime exemption that is used during his or her lifetime reducing the individual's exemption available at death. As such, in 2026 the exemption on death is set to return to half of this amount, back to the 2011 tax year amount of $5,000,000, adjusted for inflation.

An important and relatively new concept in regards to the U.S. estate tax is the notion of "portability". For tax years prior to 2011, if a U.S. individual died and failed to use all of his or her lifetime exemption or exemption on death, that unused portion was lost forever. However, as a result of the *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010* (the "2010 *Tax Act*") passed at the end of 2010, a U.S. citizen or domiciled surviving spouse is able to elect to use the unused portion of his or her deceased spouse, referred to as "portability". Therefore, under the TCJA, and until 2026, as between two U.S. citizen or domiciliary spouses there is an ability to exclude from U.S. gift and estate tax a cumulative amount of $20,000,000, as adjusted for inflation. Note that a deceased spouse's unused exemption amount is set at the time of death and not adjusted for inflation for years after death.

As with the U.S. gift tax, in addition to the exemption on death, there are certain deductions and credits available from U.S. estate tax that are outside of the scope of this paper.

C. U.S. Generation-Skipping Transfer Tax

In addition to the U.S. gift tax and the U.S. estate tax, there is a third U.S. transfer tax that is often forgotten, which is the U.S. generation-skipping transfer ("**GST**") tax. As its name suggests, it is a tax imposed on transfers, outright or in trust, if the transfer would otherwise avoid incurring the U.S. gift or estate tax at each generation level.

As with the prior two transfer taxes, each U.S. citizen or U.S. domiciliary is entitled to exempt an amount on generation-skipping transfers. The exemption can be applied by such individual, during his or her lifetime, or his or her executor, on death, to any property of which such individual is the transferor.[10] As opposed to the U.S. estate tax, the GST tax exemption is not portable and therefore, unlike the exemption on death, the GST tax exemption dies with the transferor.

The GST tax exemption and rates in 2017 mirrored the U.S. gift and estate tax at $5,000,000, adjusted for inflation in 2017 to $5,490,000 with a top rate of 40%. The TCJA continued this mirroring, with the

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10 IRC section 2631(a).

GST tax exemption for 2018 doubled to $10,000,000, adjusted for inflation in 2018 to $11,180,000 with a top rate of 40%.

The following example illustrates the punitive impact of the GST tax, if it is not avoided. Assume a U.S. citizen client wished to make a $1,000,000 direct gift to the client's grandchild, but the client had previously used up his or her GST and gift tax exemption. For purposes of simplicity, also assume that no other exclusions applied to this gift. The GST tax imposed would $400,000 ($1,000,000 x 40%). The gift tax would be imposed on the $1,000,000 gift *plus* the $400,000 of GST tax paid for a total taxable gift of $1,400,000. Assuming the client is at the highest rate of 40% in 2018, the gift tax would be $560,000. Therefore, the total taxes for the transfer of $1,000,000 are $960,000 (GST tax of $400,000 + gift tax of $560,000).

III. Planning Opportunities

With the transfer tax exemptions at an all-time high, certain planning opportunities have now either become available for high net worth clients, or have just become more attractive given the potential for even more tax savings. We discuss below how the double transfer tax exemptions can be used to reduce or eliminate U.S. income tax, U.S. expatriation tax, and even Canadian tax.

A. Trust Planning for U.S. Beneficiaries

A primary goal of most high net worth clients is to preserve their wealth and pass it on in a tax-efficient manner to younger generations. However, a U.S. citizen client resident in Canada has the U.S. transfer tax rules to contend with. One option sometimes offered to such clients is "dynasty trust" planning, either through *inter vivos* or testamentary trusts.

We also touch briefly on trust planning opportunities available for Canadian citizen clients resident in Canada who have U.S. resident beneficiaries, and planning opportunities that could reduce or eliminate both U.S. estate tax for the U.S. resident beneficiaries *and* Canadian tax for the Canadian parents.

1. *Inter Vivos* Trust Planning for the U.S. Settlor

a. Generally

The substantial lifetime and GST tax exemptions have provided many high net worth U.S. clients with the current opportunity to transfer extensive wealth to their children or other beneficiaries, with no taxes owing by the beneficiaries during the U.S. settlor's lifetime. Some clients have questioned whether in 2026 when the exemptions are returned back to the 2010 Tax Act amounts, as adjusted for inflation, if gifts made in prior years in *excess* of the 2026 exemption could be subject to U.S. gift tax at such time, commonly referred to as “clawback”. However, most, if not all, U.S. planning practitioners believe a clawback would be very unlikely.

b. The Mechanics

Inter vivos trust planning involves a U.S. client settling a Canadian resident trust with non-appreciated assets. The trust is drafted to trigger both subsection 75(2) of the Canadian *Income Tax Act* (the “**ITA**") and one or more grantor trust provisions of the IRC[11] such that the income, gain, and loss of the trust are taxed to the U.S. settlor personally, both for Canadian and U.S. income tax purposes, with foreign tax credits available to eliminate any double tax. With the U.S. settlor responsible for the taxes, and not the U.S. beneficiaries, the U.S. settlor further reduces his or her estate without creating any additional U.S. gift tax liability as taxes are paid by the settlor on the trust’s behalf.

Although the trust would be drafted as taxable to the U.S. client for U.S. *income* tax purposes, it would be drafted to be *excluded* from the settlor’s estate for U.S. estate tax purposes, requiring that the settlor have no rights or interests in the trust, as determined by the U.S. estate tax rules. [12] In addition, it is drafted to be excluded for U.S. estate tax purposes from the estates of each of the beneficiaries of the trust.

c. Tax-free Distributions Received During the Settlor’s Life

While a U.S. beneficiary would have an obligation to file a U.S. informational return reporting a distribution from the trust, during the settlor’s lifetime the distributions are not taxable to the U.S. beneficiary, but instead to the settlor. If income is paid to a U.S. resident from the trust, the Trustee would need to withhold 15% and remit it to the Canada Revenue Agency.

d. U.S. Income Tax on the Settlor’s Death

After the settlor’s death, for U.S. tax purposes the trust would become a “foreign non-grantor trust” and distributions would be taxable either in the trust or in the hands of the beneficiaries. If the U.S. beneficiary is resident in the United States, after the settlor’s death the trust could move to the United States[13] to avoid the application of the U.S. throwback rules which increase the U.S. cost to a U.S.

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11 The grantor trust rules can be found at IRC sections 673 through 679.

12 IRC sections 2033 through 2043 set forth the rules to determine what is determined to form part of an individual’s gross estate, subject to U.S. estate tax.

13 IRC section 7701(a)(30)(E) provides that a trust is a U.S. resident if: (1) a court within the U.S. is able to exercise primary supervision over its administration; and (2) one or more U.S. persons have the authority to control all

beneficiary of receiving distributions from a foreign non-grantor trust. The throwback rules are discussed in further detail below. This move would have to be carefully considered as the trust may then become a dual resident trust or in certain circumstances may cease to be Canadian resident trust, giving rise to a deemed disposition.

2. *Inter Vivos* Trust Planning for the Canadian Settlor with U.S. Resident Beneficiaries

For Canadian non-U.S. citizens, non-U.S. domiciliaries ("NRAs") an *inter vivos* dynasty trust provides even more opportunities to transfer wealth. The United States will only impose U.S. gift tax on an NRA who gifts tangible personal property or real property situated in the United States, as determined pursuant to the U.S. gift tax rules.[14] Gifts by an NRA of intangible property and any other property located outside of the United States are not subject to United States gift tax.[15] In addition, the GST tax will only apply to an NRA where the transfer would be subject to United States estate or gift tax.[16] Therefore, provided the *inter vivos* trust is funded with non-U.S. situs assets under the gift tax rules, an NRA is unlimited for U.S. tax purposes in the amount of assets that can be used to fund the dynasty trust. Of course, Canadian tax rules must be considered.

The new Canadian tax on split income ("TOSI") rules have been excellently explained in other publications and we do not expand on these here. However, the TOSI rules do not apply to prevent the splitting of income with non-residents of Canada. Thus, a Canadian *inter vivos* trust which could otherwise not permit income splitting, can make distributions to U.S. resident beneficiaries with only a

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substantial decisions of the trust. This generally requires a specific statement that a trust will be subject to the jurisdiction of a particular State and requires the trustee to be a U.S. citizen or a U.S. resident individual or entity. A U.S. resident trust avoids the throwback rules and additional reporting requirements. Such a trust may also be a Canadian resident trust, depending on the facts. The competent authority has stated it will not make a determination of whether a trust is resident in the U.S. or Canada; thus, a dual resident trust must typically rely on foreign tax credits to reduce or eliminate any double taxation.

14 IRC sections 2501 and 2511(a).

15 The IRS has determined that currency and cash are tangible, rather than intangible, personal property and therefore potentially subject to U.S. gift tax. Treasury Regulation section 25.2511-3(b)(4); G.C.M. 368560 (September 24, 1976; unpublished). However, if the transfer of funds occurs outside of the United States, the gift should not be subject to United States gift tax. Pre-arranged gifts of intangible property, which are subsequently used by the donee to purchase real or tangible personal property having a U.S. situs, may result in the imposition of gift tax. See *Geoffrey C. Davies v. Commissioner*, 40 T.C. 525 (1963) acq. 1966-1 C.B.2.

16 Treas. Reg. section 26.2652-1(a)(2).

15% Canadian withholding tax rate. In the narrow circumstances in which the Canadian trust is taxable to a non-U.S. Canadian resident under the U.S. grantor trust rules, the total tax payable would be this 15% tax.

3. Testamentary Trust Planning

a. Generally

A dynasty trust can also be created on death, pursuant to the terms of the deceased's Will or other estate planning documents. A U.S. citizen decedent can fund a dynasty trust with whatever portion of the deceased's U.S. GST tax exemption remains. As stated above, for an NRA the GST tax will not apply provided the transfer is not subject to United States estate tax on death.[17] An NRA will only be subject to U.S. estate tax on property situated in the United States, as determined by the U.S. estate tax rules[18] which, notably, are different then the U.S. gift tax rules. Of most relevance to NRAs, this would include stock in a U.S. domestic corporation and U.S. real estate.[19] There are credits available to an NRA under the IRC, as well as enhanced credits under the Canada - United States Tax Convention (1980), the review of which are outside the scope of this paper. The important takeaway when considering dynasty trust

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17 Treas. Reg. section 26.2652-1(a)(2).

18 IRC section 2104.

19 The following is considered to be property within the United States pursuant to IRC section:

(1) real property located in the United States;

(2) tangible personal property physically located in the United States except for:

   (a) certain works of art on loan for exhibition to a public gallery or museum, no part of the net earnings of which inures to the benefit of any private shareholder or individual (Treas. Reg. section 20.2105-1(a)(2));

   (b) personal property where there is no degree of permanence (for example, personal property accompanying an NRA who dies while travelling in the United States (*Estate of Paquette v. Commissioner*, 46 T.C.M. 1400 (1983)));

(3) shares of stock issued by a United States domestic corporation, private or public, irrespective of the location of the certificates and whether or not the stock trades on a non-United States stock exchange;

(4) any debt obligations of United States persons including the United States government, a state, or political subdivision thereof, or any agency or instrumentality of any such government (Treas. Reg. section 20.2104-1(a)(7)(ii)); and

(5) an interest in a United States trust regardless of the nature of the assets held by the trust, and an interest in certain foreign trusts to the extent the trust holds property within the United States and the decedent is considered to own the trust property for United States estate tax purposes.

Treas. Reg. section 20.2105-1 contains a list of non-United States situs property that is specifically excluded from an NRA's gross estate.

planning for an NRA is that provided the trust is not funded with U.S. situs assets for U.S. estate tax purposes, there is no U.S. tax limit on funding such a trust.

b. The Mechanics

The trust is drafted so that the trust property is excluded for U.S. estate and GST tax purposes from the estates of each beneficiary. Such protection can still be achieved if the client wishes for a beneficiary to act as a co-trustee or sole trustee of the trust, provided proper restrictions are included in the trust on a beneficiary's ability, as trustee, to distribute assets to himself or herself or to appoint the trust property on the beneficiary's death.

c. U.S. Income Tax

The trust will not have the benefit of the U.S. grantor status discussed above, as it will qualify as a non-grantor trust for U.S. income tax purposes.[20] Therefore, income will be taxed either in the trust, if retained, or to the beneficiaries, if distributed, and the impact of the "throwback rules", discussed further below, must be considered.

4. Quick Tips and Traps for Trust Planning

a. Cost Base Considerations

Note that a trust which avoids U.S. estate tax does not entitle the trust assets to an automatic increase in the cost basis of the assets on the settlor's death (or the death of a beneficiary), whereas assets includible in the estate of such individual do receive an automatic increase in cost base to fair market value at the date of death. Depending on the specific assets intended to be held by the trust and the value of the settlor's or beneficiaries worldwide estate relative to the estate tax exemption, the cost basis increase may be more valuable than the U.S. estate tax protection. This is particularly the case as Canadian capital gains tax will almost always arise on the death of a Canadian resident individual in any case and be available as an offsetting tax credit against U.S. estate tax owing. Therefore, sufficient flexibility should be drafted into the trust for a potential wind-up if the tax rules or the tax attributes of the trust property would make such a wind-up advisable.

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20 Note that if not drafted properly, a dynasty trust can qualify as a grantor trust to the U.S. *beneficiary*, meaning the income, gains, and losses of the trust would be taxable to such beneficiary. See IRC section 678. Income splitting would then be ineffective.

b. Local Counsel

If a trust is to be created with a specific U.S. jurisdiction in mind, i.e. where the beneficiary resides, local State counsel should be retained to advise on the terms of the trust, especially where further non-tax advantages are desired such as protection on the breakdown of a marriage or creditor protection generally.

c. The “Throwback” Rules

IRC section 667 and its related provisions are designed to eliminate disparate tax treatment of income distributed by a foreign non-grantor trust to its beneficiaries and income retained by the foreign trust. These rules are commonly referred to as the “throwback” rules. These rules do not apply to grantor trusts.

Simply put, distributions to U.S. beneficiaries from foreign non-grantor trusts are taxed as income for U.S. tax purposes to the extent of distributable net income (“DNI”). DNI is the current year’s income, *including most capital gains*, less certain distributions. Distributions of current year income retain their character (for example, dividends, interest, capital gains) for U.S. reporting purposes. Distributions in excess of DNI are taxed as ordinary income and have an interest charge applied to the extent those distributions are from undistributed net income (“UNI”). UNI is essentially the income and capital gain that has accumulated in the trust and not been distributed in the year earned. Only after all of the DNI and UNI have been distributed will distributions be treated as a return of capital.

When UNI is distributed to a U.S. beneficiary, such income is “thrown back” to the year it was originally earned. The distribution is grossed-up for the amount of tax paid by the trust so that the beneficiary includes in income for U.S. purposes the amount of income that the trust earned calculated using U.S. rules; so, for example, capital dividends would be treated as income. The U.S. beneficiary is subject to tax based on his or her average U.S. tax rate for the previous five years on his or her share of the distributed UNI (grossed up for tax paid by the trust). Credit is given for foreign taxes paid by the trust. In addition, an interest charge will be imposed, with the amount calculated on the net tax payable and based on the number of years the trust existed.

In order to avoid the application of the throwback rules when there is a U.S. citizen or resident beneficiary of a trust, all income and realized capital gains would need to be paid out to the U.S. person instead of being retained in the trust. Since the throwback rules do not apply to U.S. domestic trusts, any trust created for a U.S. resident individual could be moved to the U.S., both by having a U.S. person or trust company act as trustee of such trust and by having the trust attorn to a U.S. State’s jurisdiction, to the extent such move is otherwise considered tax efficient.

B. U.S. Principal Residence Exemption

1. Generally

While in Canada, under current legislation, the gain on the sale of a residence is exempt from tax if certain criteria are met, U.S. citizens who own their residences in Canada may still face U.S. capital gains tax on a sale. A U.S. citizen can exempt $250,000 of the capital gain on a sale of a principal residence if the individual owned and used it as a principal residence for two out of the five years immediately preceding the sale.[21] The balance will attract tax.

The current capital gains rate in the U.S. is 20% (for years in which income and gains exceed $425,800 for a single taxpayer, $479,000 for a married taxpayer filing jointly and $239,500 for a married taxpayer filing separately). If the client files a U.S. joint return with his or her spouse as a married couple in the year of sale, the client would be able to claim a $500,000 exemption, even if the client is the sole owner of the property and the U.S. citizen spouse is not an owner. If the client instead files as a married taxpayer filing separately in the year of sale, the client and the spouse would only be able to claim a full $500,000 exemption if they are both on title to the property.

2. Planning with an NRA Spouse

As a result of exposure to U.S. capital gains tax, a U.S. citizen spouse may wish to gift his or her interest in the residence to the non-U.S. citizen spouse such that on a later sale of the property, there would be no U.S. capital gains tax exposure. The gifting can be done over a course of years, relying on an annual exclusion available for a U.S. citizen to make gifts to a non-U.S. citizen spouse in the amount of $100,000, adjusted annually for inflation and in the 2018 calendar year to $152,000, or as a one-time gift of the U.S. citizen spouse's entire interest in the residence, resulting in the use of a portion of the U.S. citizen spouse's lifetime exemption and the obligation to file a U.S. gift tax return reporting the use of the exemption. The current lifetime exemption of $11,180,000 makes the one-time gift option more attractive for those clients who previously did not want to use up their lifetime exemption as they were expected to need it to shield other assets on death from U.S. estate tax exposure.

For Canadian tax purposes the income, loss and capital gain from the gifted interest will be attributed back to the donor spouse and taxed in his or her hands. Thus, if the residence is sold after the transfer, the non-U.S. citizen spouse should avoid investing the proceeds in U.S. investments. This is because the

21 The U.S. capital gains exemption is only available for a residence "principally" used by the taxpayer. The factors considered in the Treasury Regulations in determining whether a residence is a taxpayer's principal residence include the taxpayer's place of employment; the address listed on the taxpayer's tax returns, driver's license, vehicle registration and voter registration card; the taxpayer's general mailing address; the location of the taxpayer's banks; and the location of religious organizations and recreational clubs with which the taxpayer is affiliated.

U.S. would tax the non-U.S. citizen spouse on the income generated (e.g. dividends from U.S. corporations) and Canada would tax the U.S. citizen donor spouse on the same income, and no foreign tax credits would be available.

The gift made to the non-U.S. citizen spouse must be one without strings attached or the expectation of return. Other tax and planning consequences should considered. For example, the family law consequences of the gift should be advised upon by family law counsel. In addition, the new owner should review, and potentially revise, his or her estate plan to contemplate the disposition of the residence (or net sale proceeds) on death. The potential application of the ability to vary the new owner's Will pursuant to section 60 of the *Wills, Estates, and Succession Act* should be considered.

Many clients think of their principal residence differently than their other assets, and with more sentimental attachment underlying it. As such, the gift should be made with a full understanding of the myriad of tax and planning consequences that result from such a gift, without a singular focus on the reduction or elimination of U.S. capital gains tax exposure.

C. Expatriation

Many U.S. citizen clients, when faced with the tax limitations U.S. citizenship imposes, inquire into how to relinquish U.S. citizenship, otherwise referred to as expatriation from the United States. This question of expatriation has come up with more regularity after the enactment of the TCJA. While the new U.S. transfer tax rules described above are beneficial to U.S. citizens in Canada, the TCJA also implemented a series of complex and interrelated international tax rules that have punitive application to U.S. citizens who have interests in foreign (i.e. non-U.S.) corporations. We will first briefly describe these new rules to illustrate why expatriation, now more than ever, is a tool for U.S. citizen clients to consider. We will then summarize the tax consequences of the U.S. expatriation tax, and how the new transfer tax rules can assist in accomplishing this planning.

1. New Tax Rules for U.S. Shareholders of "Controlled Foreign Corporations"

The overall purpose of these new U.S. international tax provisions is to transition to a territorial model where income is taxed based on where it is earned. Previously, the U.S. international tax system followed a "worldwide" model where U.S. businesses were taxed on all of their income regardless of where it was earned.

In order to shift to a territorial system, the TCJA imposed a tax (the "Repatriation Transition Tax") on certain foreign (non-U.S.) earnings that have traditionally not been subject to U.S. federal income tax.[22] Under the new law, accumulated foreign earnings held by a "controlled foreign corporation" (a "**CFC**") of a "U.S. shareholder" will be deemed repatriated and taxed federally in the United States at a rate of

22 IRC section 965.

15.5% if attributable to cash or cash equivalents and at a rate of 8% if attributable to illiquid assets.[23] The taxpayer may then elect to pay the resulting federal income tax liability over an eight-year period.[24] In brief, a CFC is defined as any foreign corporation if more than 50% of the combined voting power of the corporation or the total value of the stock of such corporation is owned by United States shareholders. Prior to 2018, and therefore effective for the Repatriation Transition Tax, a "United States Shareholder" meant a U.S. citizen or resident who owned or was considered to own 10% or more of the total combined **voting** power of all classes of stock of the foreign corporation that are entitled to vote.

In addition to the Repatriation Transition Tax, effective for the first tax year of a CFC beginning after December 31, 2017, any United States shareholder of a CFC[25] who directly or indirectly owns stock in the CFC on the last day of the CFC's tax year (or the last day on which the foreign corporation is a CFC) is subject to U.S. federal income tax on the owner's share of the CFC's Global Intangible Low Taxed Income ("**GILTI**").[26] GILTI is defined to include most business income of a CFC,[27] reduced by 10 percent of the adjusted tax basis of the CFC's depreciable tangible personal property (generally, plant and equipment, but not real property).

Important to understanding the substantial impact of the GILTI rules, is in understanding a change brought into effect by the TCJA to the definition of "United States shareholder". As noted above, a CFC is defined as any foreign corporation if more than 50% of the combined voting power of the corporation or the total value of the stock of such corporation is owned by United States shareholders. Prior to 2018, a "United States shareholder" was defined as a U.S. citizen or resident who owns or is considered to own 10% or more of the total combined **voting** power of all classes of stock of the foreign corporation that

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23 Unfortunately, the statutory text of section 965 leaves many open questions regarding how a United States shareholder's section 965 inclusion amount is computed. On August 1, 2018, the United States Treasury Department issued proposed regulations related to section 965. At 249 pages, the proposed regulations contain detailed information on the calculation and reporting of a United States shareholder's section 965(a) inclusion amount, as well as information for making the elections available to taxpayers under section 965.

24 If a person expatriates from the United States and qualifies as a "covered expatriate", as explained further below, the regulations released for the Repatriation Transition Tax require the entire payment of such tax for an expatriate.

25 The new GILTI rule, which is intended to subject all of a CFC's income to a minimum tax, results in a significantly higher tax cost to United States shareholders that are not themselves C corporations than to United States shareholders that are themselves C corporations.

26 IRC section 951A.

27 Certain types of income are excluded from the GILTI formula, notably income that is effectively connected to a US trade or business.

are entitled to vote. Therefore, provided the voting shares of a foreign corporation were not held by a U.S. person, a foreign corporation could never qualify as a CFC. However, effective as of January 1, 2018, a "United States shareholder" is defined as a U.S. citizen or resident who owns or is considered to own **either** (1) 10% or more of the total combined voting power of all classes of stock of the foreign corporation that are entitled to vote; **or** (2) 10% or more of the total combined **value** of all classes of stock of the foreign corporation.

With this dramatic change, even if U.S. beneficiaries of a non-grantor trust have no voting control but hold 50% or more of the value of a foreign corporation, the CFC rules will be triggered. This would be commonly seen for example in a family trust holding growth shares in a corporation engaged in a professional practice by a taxpayer who must hold all the votes of the corporation personally, such as a physician, dentist, or lawyer. Although outside of the scope of this paper, in general if a corporation qualifies as a CFC than any passive income a corporation earns is taxable to the United States shareholders on a current basis, even if distributions are not made from the corporation to the shareholders, and is taxed at ordinary income rates, rather than at preferential capital gains tax or dividend tax rates. In addition, the new GILTI rules will apply for tax years 2018 and ongoing.

In sum, for many U.S. citizens resident in Canada, the enactment of the TCJA was sufficient motivation to consider giving up U.S. citizenship once and for all. However, as illustrated below, just as U.S. citizenship comes with a price tag, so does abandoning that citizenship.

2. U.S. Expatriation Tax

Section 877A of the IRC imposes an "exit tax" on expatriates and former long-term residents.[28] Essentially, section 877A treats an individual as having sold all of his or her property immediately before expatriation and taxes the gain exceeding $600,000.[29] Further consequences will arise on other specific types of property.[30]

Section 877A applies to a former citizen or former long-term resident if that person either:

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28 A "long-term resident" is an individual who has been a lawful permanent resident (green card holder) for 8 taxable years in the 15 taxable years prior to relinquishment.

29 This amount is indexed annually for inflation and for 2018 is indexed at $713,000.

30 In addition to the deemed disposition, the expatriation tax provisions give rise to certain other U.S. tax consequences as well. These typically include a deemed inclusion in income in the year of expatriation of certain deferred compensation items (which may include an individual's RRSP), gift and estate tax imposed on the donee at the highest rate at the time (currently 40%) for gifts and bequests made to U.S. citizens and residents (with limited exceptions), and the inability to pay the Repatriation Transition Tax over eight years, along with other tax consequences outside the scope of this paper.

a) Has an average annual net income-tax liability[31] for the five preceding years that exceeds $124,000, adjusted for inflation in 2018 to $165,000; or

b) Has a net worth as of the date of expatriation of $2,000,000; or

c) Fails to certify under penalty of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years and provide any evidence of compliance as required by the IRS.

Generally, if any of the above applies, an individual will be considered a “covered expatriate” and certain punitive tax consequences will follow. There are exceptions from the first two criteria for certain individuals who have been dual citizens since birth. [32] There is no exception from the tax compliance requirement.

3. Net Worth Planning

The above illustrates that the cost of expatriation without planning can be significant. While there may be available planning to ensure compliance with items (a) and (c) above, the following provides planning options for those clients needing to reduce their net worth on the date of expatriation below $2,000,000.

With the current gift tax exemption at a historical high of $11,180,000 and set to expire at the end of 2025, many U.S. citizens with significant wealth may now have an option of expatriating without exceeding $2,000,000 of net worth and therefore being classified as a “covered expatriate” and the punitive tax consequences that follow.

As with the gift of an interest in a residence, similar risks and planning should be considered. Any gifts made must be without strings attached or the expectation of return. If to a spouse, or even a donee who is married, the family law consequences of the gift should be advised upon by local family law counsel.

Additionally, U.S. Form 8854, which must be filed following expatriation, provides in its instructions that if there have been significant changes in the individual’s assets and liabilities for the period that began

31 If the taxpayer is filing as “married filing jointly”, the taxpayer’s and the taxpayer spouse’s combined tax liability would be the relevant figure.

32 There are two exceptions to the application of (a) and (b). The first is for an individual who became at birth a citizen of the U.S. and a citizen of another country, and, as of the expatriation date, the individual continues to be a citizen of, and is taxed as, a resident of that other country. In addition, the individual has been a resident of the U.S. for no more than 10 taxable years during the 15 taxable year period ending with the taxable year during which the expatriation date occurs. The second exception is for individuals who expatriate before the age of 18 ½.

five years prior to expatriation or termination of residency and ended on the date of filing Form 8854, the individual must attach a statement explaining such changes. However, pursuant to U.S. tax law, forms and instructions do not have the force of law unless the government is given authority by statute to prescribe rules via forms and instructions. The statutory provision outlining Form 8854 does not authorize the government to do so. Even so, in limited cases the courts have cited forms and instructions to bolster their analysis but there should be no obligation to follow Form 8854's instructions to provide information regarding the gifting. Regardless, if a U.S. gift tax return is required to be filed by the taxpayer to report the gift and the use of the lifetime exemption, the IRS would have notice of the transfer in any event.

IV. Conclusion

The enactment of the TCJA brought with it historically high transfer tax exemptions. With these high exemptions, planning opportunities have developed for those U.S. citizens with significant wealth who were otherwise limited in their ability to transfer assets, either during their lifetime or on death. However, while in one hand the TCJA brought with it greater opportunities for U.S. clients, it also penalized many U.S. clients with non-U.S. corporate interests, who are now looking for an exit strategy from the United States. Regardless of the planning being undertaken, ensure your clients have a full understanding of the numerous tax and planning consequences that result when trying to coordinate both Canadian and U.S. tax and estate planning laws in a cohesive and efficient manner.