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GROUP AT SUN LIFE FINANCIAL

Financial Advisor

July 2015

Unique estate risks of "U.S. person" clients

Identify U.S. citizens, residents or domiciliaries to limit U.S. taxes

U.S. transfer tax laws can apply to people who never thought they were Americans. This bulletin helps you identify who may have a liability. You may want to read it together with our other bulletins, "U.S. Taxes for Canadians with U.S. Assets".

U.S. tax net reaches far and wide

Anyone who is a "U.S. person" must file a U.S. income tax return, regardless of where they live. Also, the executor of a deceased U.S. person must file a U.S. estate tax return within nine months of death. There are three categories of "U.S. persons": U.S. citizens, U.S. residents, and U.S. domiciliaries. Depending on what category a client fits into, they or their estates may have a greater or lesser obligation to pay estate (and possibly generation skipping transfer) taxes (GSTT).

Estate tax is generally assessed on the gross worldwide estate when a "U.S. person" dies. GSTT is a separate tax on gifts made during life or at death to a "skip" generation person (generally someone more than one generation removed from the person making the gift, like a grandchild or great grandchild).

Different classes of persons subject to U.S. taxes

U.S. citizens

If you are a U.S. citizen, you must file a U.S. tax return, and you may owe taxes to the United States regardless of where you live. Your tax liability includes income, estate, gift and GSTT. You are considered a U.S. citizen if:

- You were born in the U.S. and have not relinquished your U.S. citizenship, even if you no longer live in the United States.
- You were born outside the U.S., but your parents were U.S. citizens, and satisfied the residency requirements necessary for passing U.S. citizenship to you.
- You were born outside the U.S., but later became a U.S. citizen, usually by immigrating to the U.S. and becoming a naturalized U.S. citizen.
- You have dual citizenship (for example, you were born in the U.S. to Canadian parents), even if you no longer live in the United States.

The laws governing derivative citizenship (i.e. U.S. citizenship obtained from being born outside the United States through parents or grandparents who were U.S. citizens) are complicated and have changed many times. It is possible to be a U.S.

citizen yet not know it. That may be good news for clients who want to live and work in the United States, but bad news from a tax perspective.

Clients who have just discovered that they are U.S. citizens may owe back taxes, penalties and interest to the IRS for income, gift tax and GSTT, and for failure to file asset reporting forms.[1] However, the IRS has a voluntary disclosure program that lets taxpayers become compliant with the U.S. tax system without being prosecuted for tax evasion. But the client must approach the IRS first. If the IRS discovers the problem on its own, it may take a harder line.[2] Clients who discover that they are U.S. citizens should speak with a qualified tax advisor to discuss their options and obligations.

However acquired, U.S. citizenship can be relinquished. But if one of the client's reasons is to escape U.S. tax liability, the United States can continue to impose taxes on the client for up to 10 years after the client gave up their citizenship (IRC §877). Further, escaping taxes will be presumed as a reason for relinquishing citizenship if the individual's average annual net income tax for the five tax years preceding loss of U.S. citizenship exceeds $160,000 U.S. (2015 amount adjusted for inflation annually), or if their net worth as of such date equals or exceeds $2,000,000 U.S.[3] The U.S. State Department says that "persons who wish to renounce U.S. citizenship should also be aware that the fact that a person has renounced U.S. citizenship may have no effect whatsoever on his or her U.S. tax … obligations."[4]

U.S. citizens and long term green card holders also face an exit tax. They are deemed to have disposed of all their capital assets for fair market value on the day before they expatriate. They must recognize and pay tax on any unrealized capital gains on those assets in excess of $690,000 (2015 amount, adjusted for inflation). Long term green card holders get a partial exception: only the capital gains accrued from the date the green card holder became a resident of the United States are counted.

There is an exception for U.S. citizens who acquired dual citizenship through birth, have lived in and paid taxes to the other country, and have had no substantial connection with the United States.

Permanent residents

Permanent residents of the U.S. are also considered "U.S. persons". A U.S. permanent resident is someone who has an alien registration card (also known as a green card). To the IRS, holding a green card proves intent to have U.S. domicile, even if you in fact live outside the U.S. Further, many people residing and working in the United States on a visa may also be subject to U.S. tax laws.

U.S. domiciliaries

"Domicile" is a legal concept that reflects a person's intention to remain in or return to a particular jurisdiction regardless of their current location or nationality. People are considered "U.S. persons" for the purpose of transfer taxes if, when they die, they are domiciled in the United States.

Someone who is not a U.S. citizen acquires U.S. domicile by living in the United States even for a brief period of time with the intent to remain indefinitely (Treas. Reg. §20.0 – 1(b)(1)).

Some of the factors that determine domicile are:

- A person's length of stay in the U.S. and the frequency of travel away from the U.S.
- The value, nature and permanency of the individual's housing abroad and in the U.S. Some of the factors affecting that question include whether you own or rent your house, whether your house is a seasonal versus permanent property, and whether it is located in a resort or elsewhere.
- The location of any expensive personal possessions, especially if they are sentimental in nature.
- The location of the individual's business interests.

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[1] For example, FinCEN Form 114 (supersedes Form TD F 90-22.1): Report of Foreign Bank and Financial Accounts, Form 926: Return by a U.S. Transferor of Property to a Foreign Corporation, Form 3520: Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, Form 3520-A: Annual Information Return of Foreign Trust, Form 5471: Information Return of US Persons with Respect to Certain Foreign Corporations, Form 8621: Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, Form 8858: Information Return of U.S. Persons with Respect to Foreign Disregarded Entities, Form 8865: Return of U.S. Persons With Respect to Certain Foreign Partnerships, and Form 8938: Statement of Specified Foreign Financial Assets. This is not necessarily a complete list.

[2] See generally Steve Trow and Charles Bruce, "U.S. Citizens Who Don't Know It," Legal Times, vol. XXX, no. 13, March 26, 2007.

[3] See Instructions to Form 8854 Expatriation Information Statement, at www.irs.gov/pub/irs-pdf/i8854.pdf.

[4] See the discussion under "E. TAX & MILITARY OBLIGATIONS /NO ESCAPE FROM PROSECUTION" at http://travel.state.gov/law/citizenship/citizenship_776.html

- The location of close family and friends.
- The location of organizations where the individual maintains memberships, like churches, clubs and civic organizations.
- Declarations the individual has made in official documents, including those made in tax returns, wills, trusts, visa and passport applications, driver and voter registrations, and in other official documents.
- The reasons for having left the U.S.[5]

Interestingly, immigration status does not affect the question of domicile. A person may be illegally present in the United States yet still intend to remain indefinitely. A person could also be present in the United States legally on a temporary visa, but may still intend to remain indefinitely, as indicated by applying for permanent residence status before their visa expires. Even if that person never applies for permanent residence status, they could still be treated as having been domiciled in the U.S.

What about the tax treaty? Although Canada has a tax treaty with the United States the treaty does not define the term “domicile”.

Non-residents

For transfer tax purposes, the important difference between a non-resident and a citizen, permanent resident or domiciliary is that the estate of a non-resident faces potential U.S. estate tax liability only on their “U.S. situs” assets,[6] whereas the estate of a citizen, permanent resident or domiciliary faces estate taxation on all of their property, anywhere in the world.

Special note

The U.S. rules for determining citizenship, residency and domicile are complex and different from those in Canada. If you are unsure of a client’s potential status, it is best to seek qualified U.S. advice.

Example of estate and generation skipping transfer taxes

We discussed the rules aimed at taxing Canadian non-resident owners of U.S. property in our bulletin, “U.S. Taxes for Canadians with U.S. Assets”. The following is a brief synopsis of how the estates of those who are subject to the U.S. transfer tax system will be treated.

Canadian citizen/residents owning no U.S. assets

Robert, an affluent Canadian citizen living in Canada, owns a $6 million life insurance policy naming Anne, his granddaughter, as beneficiary. Robert also owns $2 million in other property situated in Canada. When Robert dies, Anne will receive $6 million tax-free as proceeds from the insurance. There may be tax consequences associated with the deemed disposition of Robert’s other property. If part or all of that property had unrealized capital gains, they would be realized on Robert’s death and there could be tax consequences. If not, or if an exemption applied (such as the principal residence exemption), there may not be any tax owing.

U.S. citizens, permanent residents and domiciliaries

If Robert were a U.S. citizen, permanent resident or domiciliary (a U.S. person), the value of the life insurance proceeds would be added to the value of his worldwide estate and would be subject to U.S. estate tax. Further, since Anne is a "skip" generation beneficiary, Robert's estate could also be subject to U.S. generation skipping tax.

In this case, Robert's worldwide estate is valued at over US$8 million according to U.S. rules, which include among other things the entire value of jointly held property and gifts made within three years of death.

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[5] Jack Bernstein, Aird and Berlis, LLP, “Domicile for U.S. Estate Tax Purposes”, from Tax Profile, Vol. 7, No. 9, Sept. 2003.

[6] U.S. assets include real estate and personal property like personal possessions, furniture and cars located in the United States on a permanent basis. U.S. assets also include stocks and bonds of U.S. companies whether registered (i.e. in an RRSP or RRIF) or non-registered. U.S. business assets, stock options on shares of U.S. companies, and the death benefits of U.S. pension plans are also U.S. assets. However, U.S. assets do not include works of art that the deceased owned and which were on permanent public exhibition in the United States when he or she died, U.S. debt securities where the interest would be exempt from U.S. withholding tax, U.S. bank accounts, and shares in a non-U.S. corporation (even if the corporation owned U.S. assets). Life insurance policy death benefits on the life of a non-resident non-U.S. citizen are not U.S. assets, even if the policy was issued by a U.S. life insurance company. However, the death benefit *is* included in the value of the deceased’s worldwide estate to determine the amount of the applicable credit that the deceased’s estate may use to reduce potential estate tax liability (see discussion below regarding Canadian citizens who own property in the United States). Canadian mutual and segregated funds are not U.S. assets even if the funds themselves own U.S. assets.

An estate tax return is due nine months after Robert's death. Not counting deductions for funeral, medical, executor and administration expenses, and other deductions to which his estate is entitled, the calculation goes like this (2015 rates):[7]

Estate tax on first $1 million	$345,800
Estate tax on balance of $7 million (at 40%)	$2,800,000
Total tentative tax	$3,145,800
Less applicable credit	$2,113,800
Estate tax	$1,032,000

In addition, Robert's estate would have to file a GSTT return because Anne is more than one generation removed from Robert. However, it is unlikely that Robert's estate would pay any GSTT because the exemption equivalent, $5.43 million, is the same as the estate tax exemption equivalent, and is applied in addition to the estate tax exemption. Robert's estate would therefore have to exceed $10.86 million before it became liable to pay GSTT.

There are steps that Robert could take to protect the value of his estate. For example, if he had created an irrevocable life insurance trust (ILIT) to apply for and own the insurance policy on his life, the entire death benefit would have been excluded from his taxable estate for estate tax and GSTT purposes. Such a step would have eliminated estate tax altogether. The severity of the U.S. estate and GSTT systems, and the steps that can be taken to eliminate it, mean that U.S. citizens, permanent residents and domiciliaries need specialized tax advice regarding any potential U.S. transfer tax liability.

For Canadian citizens who own property in the United States (i.e. non-residents)

If Robert were a Canadian citizen not domiciled in the United States, and not a green card holder, his estate would pay estate tax and GSTT only on the value of his U.S. situs assets. We'll assume for this example that Robert's $2 million in other property is all U.S. situs property, instead of Canadian property as in the first example. The life insurance policy death benefit is excluded from Robert's taxable estate since he is a not a U.S. person.

Under the Canada-U.S. Tax Treaty (the Treaty) Robert's estate could claim the same applicable credit that the estate of a U.S. person could claim, but limited to the proportion that his U.S. situs assets bear to his total worldwide estate. In determining that proportion, the Treaty requires Robert's executor to calculate the value of Robert's total worldwide estate according to U.S. domestic law. That means that Robert's worldwide estate would have to include the value of his U.S. situs property plus the value of his life insurance policy death benefit.

In this example, Robert's total worldwide estate equals $8 million (his $2 million in U.S. situs assets plus the $6 million life insurance policy death benefit), while his U.S. situs assets equal $2 million. Robert is therefore entitled to only one quarter of the applicable credit that a U.S. person would be entitled to ($2 million / $8 million).

Robert's estate tax calculation would therefore be as follows (2015 rates):

Estate tax on first $1 million of U.S. assets	$345,800
Estate tax on balance of $1 million (at 40%)	$400,000
Total tentative tax	$745,800
Proportionate applicable credit (¼ of $2,113,800)	$528,450
Estate tax due	$217,350

GSTT is also levied on U.S. situs assets owned by non-U.S. persons at death. Because Robert's proportionate GSTT exemption (¼ of $5.43 million, or $1,357,000) plus the estate tax exclusion (also ¼ of $5.43 million, or $1,357,000), exceeds the value of his U.S. situs assets, $2 million, his estate would pay no GSTT.

Even though the death benefit from Robert's life insurance policy was not subject to estate tax, it was included as an asset to determine how much of the applicable credit his estate could use to shelter his U.S. situs assets from estate tax. If he had had an ILIT apply for and own the policy, the policy would have been excluded from that calculation, and he could have used the entire applicable credit to shelter his U.S. situs assets from estate tax. The result would have been zero estate tax.

[7] See Internal Revenue Code (IRC) §2001(c) for estate tax rates and §2010(c) for applicable credit amounts.

U.S. citizens living in Canada

The reporting and information sharing provisions of the Foreign Account Tax Compliance Act (FATCA) went into effect on July 1, 2014. Under an intergovernmental agreement that Canada has with the United States, U.S. citizens living in Canada will have to identify themselves to their Canadian financial institutions when they own or purchase certain wealth or insurance products. A full discussion of FATCA and the intergovernmental agreement is beyond the scope of this article. But no action is required when the U.S. person owns only registered products (like RRSPs and RRIFs), term life insurance policies, or cash value life insurance policies with cash values of $50,000 or less (in U.S. dollars). The U.S. citizen's financial institution(s) will report that information to the Canada Revenue Agency (CRA) which will share it with the IRS under the provisions of Canada's tax treaty with the United States. The IRS hopes that FATCA and the intergovernmental agreement will encourage more American citizens living abroad to become compliant with the U.S. tax system since it will be more difficult for them to avoid IRS scrutiny.

How you can help

- Have a process to identify clients who might be considered "U.S. persons".
- Access qualified U.S. tax and legal advice to evaluate the situation. The cost of professional advice may be modest compared to the potential tax liability.
- Suggest to your "U.S. person" clients that they meet with an experienced cross border financial planner to discuss any U.S. tax liabilities and reporting obligations they may have.
- When a U.S. person needs life insurance on their own life, or is contemplating ownership of a policy on another person's life, consider alternatives to having the "U.S. person" own or control the policy in order to avoid potential estate tax consequences and foreign asset reporting obligations.

Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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First published September 2009

Last revised July 2015

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810-4327-Digital-07-15