Tax and Estate Consequences of Investing in U.S. Securities

As a Canadian resident you pay Canadian income taxes on your worldwide investment income. Since Canada represents only a small percentage of the world markets, it makes sense that your portfolio includes some foreign securities. If you own U.S. securities such as stocks issued by a U.S. corporation or real property located in the U.S., you may also have to pay U.S. income and estate tax. It is important to note that even though some U.S. securities also trade on a Canadian stock exchange, those securities are still considered U.S. property and the withholding and estate tax rules will apply. However, there are ways to take advantage of reduced U.S. withholding taxes on certain securities, and general planning techniques to minimize your U.S. estate tax.

This article is written for Canadian residents investing in U.S. securities and is not applicable to U.S. citizens residing in Canada, U.S. residents (including Green Card holders) or Canadian citizens residing in the U.S., since they face very different U.S. tax consequences. The information provided is general in nature and does not take into account individual circumstances. Cross-border taxation and U.S. estate tax are both very complex issues. Accordingly, investors and potential investors should consult their own independent professional tax advisors who specialize in these areas.

U.S. Withholding Tax on Dividends and Interest Paid on U.S. Securities

The U.S. non-resident withholding tax rate is generally 30 per cent. However, under the terms of the Canada-U.S. Income Tax Treaty (the "Treaty"), a Canadian resident individual will pay a lower withholding rate of 15 per cent on dividends, whereas interest payments are generally no longer subject to withholding tax.

At BMO Financial Group, withholding taxes are remitted directly to the Internal Revenue Service (IRS). The amounts withheld are reflected on all client account statements and income tax slips. The dividends and interest received will be net of the U.S. withholding taxes paid (if any), and no further remittance to the U.S. government is generally required.

Exemptions From Withholding Tax

As a result of the Treaty, U.S. source interest payments (with certain exceptions, such as contingent interest) to Canadian residents are not subject to any withholding tax. In addition, the Treaty provides an exemption from U.S. tax for dividends and interest earned in the United States by arrangements operated exclusively to administer or provide pension, retirement or employee benefits. This means that dividends and interest earned directly on U.S. securities held in an RRSP and RRIF will generally be exempt from U.S. withholding tax. However, this exemption does not extend to U.S. source investment income earned within a TFSA or RESP. Given the tax-free nature of a TFSA or RESP account, any withholding tax is not recoverable as a foreign tax credit to the account (or its owner). As such, this unrecoverable U.S. withholding tax represents a 'cost' in considering the viability of the investment in these accounts.

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Canadian Tax on Dividends and Interest Paid on U.S. Securities

In taxable accounts, both dividends and interest from U.S. stocks and bonds or other U.S. debt are included in calculating Canadian taxable income on a gross basis. Where U.S. withholding tax has been paid, Canada allows a credit for the U.S. tax paid (or the proportion of your Canadian tax attributable to income from the U.S., if less) from your Canadian taxes otherwise payable. In addition, if the amount of U.S. tax paid for the year exceeds the applicable Canadian tax, the excess U.S. tax may be deductible from your Canadian taxable income.

U.S. and Canadian Tax on Capital Gains From U.S. Stocks or Bonds

A Canadian resident is not generally subject to U.S. tax on gains from U.S. stocks or bonds unless the investor has a greater than 5 per cent interest in a U.S. corporation, and the U.S. corporation's principal assets derived their value from U.S. real estate; such as U.S. real estate companies or mining companies.

Therefore, most capital gains realized on the sale of U.S. stocks or bonds are taxable only in Canada. The taxable capital gain (50 per cent of the actual capital gain) is included in taxable income on your Canadian tax return. Any foreign currency exchange gain or loss is also included in your Canadian taxable income calculation.

U.S. Estate Taxes[1]

The U.S. imposes an estate tax on all individuals, including Canadian residents, who own certain U.S. assets with a combined fair market value in excess of $60,000 at the time of their death. This is because all non-resident 'aliens' of the U.S. are permitted an estate tax credit of $13,000 against the U.S. estate tax payable (which provides a shelter for up to $60,000 of taxable U.S. property). From a typical Canadian perspective, U.S. assets include real property (such as a vacation property located in the U.S.), and stocks (or options to acquire stocks) issued by a U.S. corporation, even if held in Canadian brokerage accounts; including RRSPs, RRIFs and TFSAs.

U.S. Estate Tax Rates (in $US)

If the taxable amount is:			Tax rate on excess over (1)
Over (1)	But not over (2)	Tax on (1)	
$0	$10,000	$0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,800	39%
$1,000,000		$345,800	40%

Source: Wolters Kluwer Limited, CCH

In Canada there is no estate tax or inheritance duty. However, Canada does impose tax on unrealized capital gains at death by deeming the assets to be sold at their fair market value at the date of death[2]. This is applicable to all securities, including U.S. securities. The accrued capital gain (or loss) is included as income on the deceased's final Canadian income tax return.

In contrast, U.S. estate tax is imposed on the fair market value of the property, rather than on the cost or appreciation of the property. As the chart above shows, the tax rates for 2016 range from 18 to 40 per cent.

For example, an estate with taxable U.S. property of $500,000 would attract $155,800 in estate taxes (based on the table above, using the graduated estate tax rates). An estate with taxable U.S. property of $650,000 would attract $211,300 in estate taxes, calculated as follows:

- Tax on the first $500,000 = $155,800 plus
- Tax on the next $150,000 at 37% = $55,500

Please note that the actual amount of U.S. estate tax payable may be lower due to certain credits available under the Treaty.

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Treaty Relief

The Treaty provides three very important forms of relief against U.S. estate tax for Canadians that will reduce the actual amount of estate tax payable.

- For U.S. tax purposes, a Canadian resident's estate can claim a portion of the unified credit available to U.S. citizens against the estate taxes otherwise payable. For deaths in 2016, the unified credit is $2,125,800 (which equals the U.S. estate tax on $5.45 million of assets), prorated for the ratio of the value of U.S. assets compared to worldwide assets (expressed in U.S. dollars). As a result, Canadians with worldwide assets of less than $5.45 million should not have to pay U.S. estate tax. Canadians with larger estates who hold only a small portion of their wealth in U.S. assets will have access to a smaller fraction of the unified credit and may; therefore, have a large U.S. estate tax liability.
- An additional marital credit is available under the Treaty effectively doubling the unified credit where the surviving spouse inherits the U.S. property.

Example

If the value of the worldwide assets is $10,000,000 of which $1,000,000 are taxable U.S. assets, the U.S. estate tax would be determined as follows:

U.S. Estate Tax on $1,000,000	$345,800
Portion of Unified Credit: ($2,125,800 x $1,000,000) / $10,000,000	$212,580
Net U.S. Estate Tax:	$133,220

In addition, a marital credit of $212,580 is available where a surviving spouse inherits the U.S. property.

- Finally, a Canadian resident may be subject to both U.S. estate tax and Canadian income tax on accrued capital gains on the same U.S. property. The Treaty provides that U.S. estate tax payable by Canadians can be claimed as a foreign tax credit on their Canadian tax return for the year of death to reduce or eliminate the Canadian capital gains tax on the U.S. property that was subject to U.S. estate tax.

  The Treaty also specifies that a Canadian foreign tax credit may be available in respect of U.S. estate tax paid on U.S. stock options and U.S. securities held within an RRSP or RRIF to reduce the Canadian income tax otherwise payable as a result of death. However, a foreign tax credit is not available if the RRSP or RRIF is transferred to a surviving spouse on a tax-deferred basis.

The deceased's estate must file an estate tax return with the Internal Revenue Service to report and pay any estate tax for the year in which the death occurs. A return must be filed if the deceased owned U.S. property with a value exceeding $60,000, even if as a result of the Treaty there is no U.S. estate tax liability. The U.S. estate tax return must be filed to claim the benefits provided under the Treaty.

U.S. Estate Tax Planning

If you have U.S. investments, you should speak to your tax advisor about strategies available to minimize your U.S. estate tax liability. Some of the more popular strategies include the following:

- Holding U.S. securities in a Canadian corporation. U.S. investments owned by a Canadian corporation are not generally subject to U.S. estate tax.
- Investing in Canadian mutual funds that invest in U.S. securities.
- Transferring U.S. property to a surviving spouse through a Qualifying Domestic Trust (QDOT) to defer the payment of U.S. estate tax until the death of the second spouse. In order for the Trust to qualify, an individual who is a citizen of the United States or a U.S. corporation must serve as one of the trustees of the QDOT.

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- Using 'criss-cross' spousal Trusts in the Wills to access the marital credit on the first death and reduce the value of U.S. assets and worldwide assets of the surviving spouse.
- An outright gift of U.S. stocks to family members will reduce the taxable estate if made before death. There is no U.S. gift tax imposed on the gift of stock of a U.S. corporation from a non-U.S. person.
- Obtaining life insurance in an amount sufficient to cover the U.S. estate tax. Life insurance proceeds are not subject to U.S. estate tax (although the proceeds are included in valuing the worldwide estate).
- Making an in-kind donation of U.S. assets to a qualifying U.S. charity.

A popular strategy to reduce Canadian probate costs is for spouses to hold assets in joint ownership with rights of survivorship. However, this is not an effective strategy to reduce U.S. estate tax because when a co-owner of a joint account dies, the U.S. deems that person to own 100% of the account unless contributions by the surviving owner can be proven.

For more information on U.S. estate tax, please ask your BMO financial professional for a copy of our publication entitled **U.S. Estate Tax for Canadians.**

[1] All figures used to calculate U.S. estate tax are shown in U.S. dollars.

[2] Subject to a qualifying transfer at death to a surviving spouse or spousal trust.

Note also that all Provinces and Territories (except for Quebec) impose an estate administration tax (i.e., probate on the value of an estate).

Canadian Foreign Reporting Requirements

Another issue to consider when investing in U.S. securities is the Canada Revenue Agency's requirement to annually report foreign investment assets where their aggregate cost exceeds CDN$100,000 at any time during the year.

Foreign investments include:

- Shares, bonds or other securities issued by foreign corporations (public or private)
- Funds in foreign bank accounts
- Debt of foreign governments (such as U.S. Treasury Bills)
- Certain mutual funds offered by foreign companies in Canada
- Shares, bonds or other securities issued by Canadian corporations but held outside Canada
- Interests held in foreign rental properties
- Foreign trusts and partnerships, including limited partnerships

The filing requirements do not include investments within an RRSP or RRIF. Failure to file the form when due, or failure to disclose the relevant information, will result in penalties.

Conclusion

Investors with significant foreign investment assets should consult with their tax advisor(s) to determine how income taxes, U.S. estate taxes and the Canadian foreign reporting rules affect them and what planning opportunities might be available.

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