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

As a Canadian resident you will pay Canadian income taxes on your world-wide 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 currently 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 would 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, former long-term U.S. residents 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 cannot take into account individual circumstances. Cross-border taxation and U.S. estate tax are both very complex. 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%. 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% on dividends and, as a result of recent changes to the Treaty, may avoid U.S. withholding tax on interest received from the U.S.

Withholding taxes are remitted to the U.S. government by BMO Nesbitt Burns. The amounts withheld are reflected on all account statements and income tax slips. The dividends and interest you receive will be net of the U.S. withholding taxes paid (if any) and no further remittance to the U.S. government is generally required on your part.

Exemptions from withholding tax

As a result of recent changes to the Canada–United States Tax Treaty, U.S.-source interest payments (with certain exceptions, such as contingent interest) to unrelated Canadian-residents will no longer be subject to any withholding tax, as of January 1, 2008. Cross-border interest payments to related lenders will be reduced and ultimately eliminated over a phasing-in period of several years.

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.

Canadian tax on dividends and interest paid on U.S. securities

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% 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% of the actual capital gain) is included in taxable income on the Canadian tax return. Any foreign 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 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 (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 home 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 and RRIFs.

In Canada there is no estate tax or inheritance duty. Canada does impose tax on unrealized capital gains at death by deeming the assets to be sold at 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 in income on the decedent'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 following chart shows, the marginal tax rates range from 26% to 45% for estates in excess of $1.5 million.

U.S. Estate Tax Rate Table (in U.S. $)

Taxable U.S. Property	Estate Tax	Marginal Tax Rate
$60,000	$13,000	26%
$80,000	$18,200	28%
$100,000	$23,800	30%
$150,000	$38,800	32%
$250,000	$70,800	34%
$500,000	$155,800	37%
$750,000	$248,300	39%
$1,000,000	$345,800	41%
$1,250,000	$448,300	43%
$1,500,000	$555,800	45%

For example, an estate with taxable U.S. property of $1,000,000 would attract $345,800 in estate taxes. An estate with taxable U.S. property of $1,150,000 would attract $407,300 in estate taxes, calculated as follows:

- Tax on the first $1,000,000 = $345,800 plus
- Tax on the next $150,000 at 41% = $61,500

The actual amount of U.S. estate tax payable may be lower due to certain credits available under the Canada-U.S. Income Tax Treaty.

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.

- The U.S. will allow a Canadian resident's estate to claim a portion of the unified credit available to U.S. citizens against the estate taxes otherwise payable. For deaths in 2009, the unified credit has been increased to $1,455,800 (which equals the U.S. estate tax on $3.5M of assets), prorated for the ratio of the value of U.S. assets compared to worldwide assets (expressed in US dollars). As a result, Canadians with worldwide assets of less than $3,500,000 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 as determined above where the surviving spouse inherits the U.S. property.

Example:

If the value of the worldwide assets is $5,000,000 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: ($1,455,800 x $1,000,000) / $5,000,000	($291,160)
Net U.S. Estate Tax:	$54,640

A marital credit of $291,160 is available where a surviving spouse inherits the U.S. property.

- Finally, since 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, double taxation may result at death unless an offsetting credit is granted.

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. In addition, another recent change to the Treaty clarifies 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/RRIF to reduce the Canadian income tax otherwise payable as a result of death.

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. In addition, certain U.S. tax forms must be filed to claim the benefits provided under the Treaty.

In June 2001, the U.S. federal government introduced significant changes to their estate tax rules. These changes benefitted all Canadians who own U.S. property. The top estate tax rate was previously 55% but is now 45% for deaths in 2009. This 45% rate applies until 2010 when estate taxes are scheduled to be repealed. Unless the rules are re-enacted, for 2011 and future years the law reverts back to the prior 2001 estate tax regime. However, it is widely anticipated that the 2009 rates and exemptions will be extended beyond 2009.

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 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 citizen of the United States or a U.S. corporation must serve as one of the trustees of the qualified domestic trust. This trust can be created after death.
- 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.
- 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).
- Donation in kind 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. 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 Investment Advisor for a copy of our publication entitled *U.S. Estate Tax for Canadians*.

Canadian foreign reporting requirements

Another issue to consider when investing in U.S. securities is the Canadian 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 and foreign trusts and partnerships, including limited partnerships.

The information is reported on Form T1135 and is due with the individual's personal tax return. The filing requirements do not include investments within an RRSP or RRIF. Failure to file the forms 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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[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)

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