ESTATE PLANNING DRAFTING ISSUES IN A CROSS-BORDER WORLD

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Kirstin is a Seattle native, a graduate of the University of Washington, and Baylor University School of Law. While glad to be back “home” in the Pacific NorthWest (intentional spelling), she does occasionally miss barbecue joints, the repercussions of oil and gas deals written on napkins, and the “y’alls” to which she had become accustomed while living in the South. She speaks fondly of Southern food, funny Southern family disputes, and azaleas, Magnolias, and cacti.

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These materials\textsuperscript{1} are not intended as an exhaustive summary of the issues to be considered in United States and Canadian cross-border estate planning. Instead, they are intended to highlight a few areas of typical cross-border planning issues to be considered and also to highlight certain strategies that may be utilized in some cross-border planning situations. In light of the increased media attention in Canada to the Report of Foreign Bank and Financial Accounts (“FBAR”) requirements in the United States, we will also discuss the FBAR reporting requirements and issues of interest to estate planners under the FBAR rules such as custodial accounts, attorneys-in-fact with signature authority over foreign financial accounts, and other issues.

I. Residency in Canada


II. U.S. Person/Residency in the United States

Unlike Canada, the United States has an entirely separate taxation regime for income and transfer taxes under the Internal Revenue Code (the “Code”). For the purposes of the income tax, the United States taxes “United States persons”\textsuperscript{3} on their worldwide income, regardless of source or type.\textsuperscript{4} In contrast, the United States taxes non-U.S. persons on limited types of United States sourced income and on

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\textsuperscript{1}I thank my colleagues, Eric J. Kodesch and Kristina M. Ash for their assistance with portions of these materials.

\textsuperscript{2}Subsections 2(1) and 2(3) of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), as amended and proposed to be amended, and including the regulations promulgated thereunder (the “Canadian Tax Act” or the “ITA”). Unless otherwise stated, statutory references in these materials are to the Canadian Tax Act. No assurance can be given that proposed amendments to the Canadian Tax Act will be enacted in the form proposed or at all. See also Canadian Revenue Agency (“CRA”) Interpretation Bulletin IT-221R3, December 21, 2001 and David Sherman, \textit{Practitioner’s Income Tax Act} subsection 250(1) notes (39\textsuperscript{th} ed. 2011)

\textsuperscript{3}I.R.C. § 7701(a)(30). Under the Code, a U.S. person includes individual citizens and residents, corporations, partnerships, estates and trusts in the U.S.

\textsuperscript{4}I.R.C. §§ 1, 61.
income that is effectively connected with a U.S. trade or business, regardless of source.\(^5\)

For individuals, U.S. persons include both citizens and residents of the United States as more particularly discussed below. Classification as a U.S. person also impacts reporting obligations in the United States. U.S. persons must report their worldwide income on income tax returns, file certain informational reports with their returns, and in particular, for purposes of these materials, comply with additional foreign account reporting obligations (discussed below). Foreign persons also have some reporting obligations in the United States.\(^6\)

For transfer tax purposes – U.S. Federal gift and estate taxes – the somewhat brightline tests of the income tax regime are not used. Instead, a separate subjective domicile analysis is used. For example, a Canadian citizen could be resident in the United States for income tax purposes but continue to be domiciled in Canada for estate tax purposes.\(^7\) For income tax planning and reporting obligations, a determination of U.S. person status is critical.

A. U.S. Person as a Result of Citizenship

Unlike virtually all other countries in the world, the United States taxes United States citizens without regard to actual residence. Citizenship is determined under the U.S. Constitution and the Immigration and Nationality Act ("INA").\(^8\)

Any person born within a territory of the United States, including territories such as Puerto Rico, Guam, the U.S. Virgin Islands,\(^9\) and indigenous inhabitants of the Northern Mariana Islands,\(^10\) Each of these territories extends a radius of twelve nautical miles out to sea and the United States‘ airspace. Anyone born within this radius, even if on an airplane or a foreign merchant ship, is a United States citizen.\(^11\) However, birth on a foreign public vessel (such as a foreign military ship) does not confer citizenship on the individual.\(^12\)

\(^5\) I.R.C. §§ 861, 871.
\(^6\) Foreign persons also have some of these reporting requirements. For example, Form 8833 may need to be filed in certain circumstances to claim a treaty benefit, even though no tax is owed.
\(^7\) Estate of Jack v. United States, 54 Fed. Cl. 590 (2002).
\(^8\) In particular see the United States Constitution, Fourteenth Amendment, and 8 U.S.C. § 1101, et seq.
\(^10\) Covenant of Political Union
\(^12\) INS Interpretation 301.1(a)(4)(ii), 301.1(a)(5), 301.1(a)(2).
Birth within the United States to parents who have diplomatic immunity requires analysis of diplomatic immunity classification of the parents. The U.S. State Department compiles the monthly “Blue List” and the quarterly “White List.” If a child is not accorded diplomatic immunity derived from the parent’s diplomatic immunity, then the child is subject to United States jurisdiction and is a U.S. citizen if born within the United States territories (the “White List”). If the child is accorded diplomatic immunity derived from his or her parent’s diplomatic immunity, then the child is not subject to United States jurisdiction and is not a U.S. citizen even if born within the United States territories (the “Blue List”).

Because of the Fourteenth Amendment to the Constitution, generally, citizenship in the United States is not derivative (dependent on the citizenship of the parents); however, citizenship may be derived from parents pursuant to statutory provisions. Congress has conferred citizenship upon children who are born outside of U.S. territories to U.S. citizens under certain circumstances. The determination is based on the law in effect at the time of the person’s birth. Because the laws in this area change reasonably frequently, determination of citizenship is rarely as straightforward as a non-immigration law practitioner might expect. For example, under current law, if both parents are U.S. citizens and at least one parent resided within the United States or one of its possessions at any time before the child’s birth outside of the United States, then the child is a U.S. citizen. If one parent is a citizen and the other parent is a non-citizen “national” (e.g., born in American Samoa or the Panama Canal Zone), then the child born outside of the United States is a U.S. citizen only if the U.S. citizen parent resided in the United States or one of its possessions for a continuous period of at least one year immediately before the birth of the child. If one parent is a citizen and the other parent is a non-citizen, then a child born in a United States possession is a U.S. citizen if the U.S. citizen parent resided in the United States or one of its possessions for a continuous period of at least one year at any time before the birth of the child. For children born outside of the United States to parents, one of whom is a citizen, and one of whom is a non-citizen, several rules also exist depending that determine citizenship based on facts, circumstances and the date of birth. For example, for individuals born on or after December 24, 1952 and before November 14, 1986, if one parent was a non-U.S. citizen, and one parent was a U.S. citizen, the child born outside of the United States would be a U.S. citizen if the U.S. citizen parent resided in the United States for at least ten years of his or her life and if at least five of those years were after attaining 14 years of age. Shorter time periods apply for children born after November 14, 1986. All of the different time periods and scope of circumstances of derivative citizenship are beyond the scope of these materials. For further reference, please see 7 Charles Gordon, Stanley Mailman & Stephen Yale-Loehr, Immigration Law and Procedure (1997).

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13 See INS Interpretation 301.1(a)(4)(i).
14 8 U.S.C. § 1401(c); see Weedin v. Chin Bow, 274 U.S. 657 (1927).
16 8 U.S.C. § 1401(e).
The determination that a person is a U.S. citizen who has gone through the naturalization process (the process of obtaining citizenship after birth) is usually a much easier determination. The naturalization process requires significant documentation. For a summary of the qualifications for the naturalization process for estate planners, please see Michael A. Heimos, *Immigration and Expatriation Law for the Estate Planner*, 806 T.M. Portfolios (BNA) at III.B (2007).

The tax and reporting obligations of United States citizens apply so long as the person holds U.S. citizenship. The amount of time spent outside of the United States is irrelevant and U.S. citizens and U.S. persons must annually file U.S. income tax returns that include their foreign income and all other reporting returns (e.g., the FBAR). The only way that a U.S. citizen may be relieved of these obligations is by officially giving up his or her citizenship by expatriating, which then creates results in additional reporting and tax obligations.

B. U.S. Person as a Result of Lawful Permanent Resident Status ("Green Card Holders")

Persons who have the right to legally reside in the United States as permanent resident aliens hold what is commonly referred to as a "green card." A green card holder is a U.S. income tax resident and therefore a U.S. person.\(^\text{17}\) The tax and reporting obligations for long-term green card holders (those who hold a U.S. green card for eight of fifteen U.S. tax years), even if they no longer reside in the United States, continue until such time as the individual formally expatriates. As such, long-term green card holders residing outside of the United States still must annually file U.S. income tax returns that include their foreign income and all other reporting returns (e.g., the FBAR).

C. U.S. Person as a Result of Substantial Presence Test

A person is resident in the United States and therefore a U.S. income tax resident and U.S. person if he or she meets the substantial presence test.\(^\text{18}\) If the person is physically present in the United States for at least 31 days in the present calendar year and for 183 days or more over a three-year period, then the person will be a U.S. income tax resident and U.S. person. A person is physically present in the United States if present for any amount of time. The day of arrival to and the day of departure from the United States both count toward determining the days of physical presence. Residents of Canada who regularly commute to employment within the United States may qualify for an exception to the number of days present.\(^\text{19}\) If a person is unable to leave the United States due to a medical condition

\(^{17}\) A green card holder may still be treated as a resident for tax purposes if the green card has expired.

\(^{18}\) I.R.C. § 7701(b)(3).

\(^{19}\) I.R.C. § 7701(b)(7).
that arose while present in the United States, those days will not be counted toward the number of physically present days. There are also exceptions for persons who spend less than 24 hours in the United States who are in transit between two foreign ports, as well as persons who are certain crew members on foreign vessels that are temporarily present in the United States. Certain foreign government-related individuals, certain teachers and students, as well as professional athletes present to compete in charitable sports events also qualify for exemption from the physically present test.

Physical presence during a calendar year for 183 days or more will result in the individual being a resident for tax purposes. In order to calculate physical presence for 183 days or more over a three-year period, the individual must add the total number of days the person is present during that calendar year, plus one-third of the total days present from the first preceding year, plus one-sixth of the total days present from the second preceding year. If this amount equals or exceeds 183 days then the individual is a resident of the United States for income tax purposes. In applying this test mathematically, under current law if a person always spends 121 days or less in the United States each year, then the person will never meet the substantial presence test.

While a person may meet the substantial presence test and therefore be a resident in the United States for income tax purposes, he or she may qualify for the “closer connection exception.” If the person can establish that (i) he or she was present in the United States for less than 183 days during the current year; (ii) he or she maintains a tax home in a foreign country (as defined in section 911(d)(3) of the Code); and (iii) he or she has a closer connection during the current year to the foreign country in which the tax home is located than to the United States; and (iv) he or she has not personally applied, or taken other affirmative steps, to change his or her status to that of a green card holder of the United States. A person’s tax home is located at his or her regular or principal place of business. If he or she is retired, for example, and does not have a regular or principal place of business, then his or her tax home is the person’s regular place of abode in a real and substantial sense. The determination is made on a facts and circumstances test that includes a determination of where the person’s most significant contacts are maintained, the location of the person’s family, the location of personal belongings, the location of business contacts, the jurisdiction where the person maintains his or her driver’s license and where the person votes. Additionally, several other potential factors may apply. In short, the analysis is very similar to the domicile analysis used for

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20 I.R.C. § 7701(b)(3)(D).
21 I.R.C. § 7701(b)(7)(C)–(D).
22 I.R.C. §§ 7701 (b)(3)(D) and 7701 (b)(5).
23 I.R.C. § 7701(b)(3).
25 Treas. Reg. § 301.7701(b)-(2)(c).
26 Treas. Reg. § 301.7701(b)-(2)(d).
transfer tax purposes; although, for transfer tax domicile analysis, subjective intent is determined and these are among the factors used to determine intent. A person files a Form 8840 to claim the closer connection exception to the substantial presence test and it is attached to a timely filed Form 1040NR.

D. **U.S. Person Status for Estates, Trusts, and Entities**

If (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more U.S. persons have authority to control all substantial decisions of the trust, the trust will be a U.S. person.\(^{27}\) United States partnerships, corporations, limited liability companies, and estates are also U.S. persons.

E. **Domicile Analysis**

Code sections 2033 through 2044 describe the property that is includible in the gross estate of a decedent. The gross estate of a U.S. citizen includes all of these property interests, even if the U.S. citizen lived in a foreign country at the time of his or her death.\(^{28}\) The Treasury Regulations define a “resident decedent” of the United States as a person who at the time of his or her death was domiciled in the United States.\(^{29}\) For purposes of gift and estate tax, the definitions of resident alien and nonresident alien do not apply.\(^{30}\) Because of the differences under the Code and the subjective domicile analysis, it is possible that a person could be a green-card holder who is not domiciled in the United States for transfer tax purposes. A person is domiciled in the place where he or she resides, with intent to remain permanently.\(^{31}\) The United States Supreme Court states the test as "the essential fact that raises a change of abode to a change of domicile is the absence of any intention to live elsewhere, ... or, 'the absence of any present intention of not residing permanently or indefinitely in' the new abode."\(^{32}\) Factors used to determine the subject intent of the person for domicile analysis include the motivation of the person in choosing where to live; the length of time the person resides or resided in a particular jurisdiction; the frequency of travel between the United States and the foreign jurisdiction; the relative size and cost of the person’s homes in each jurisdiction; whether the person rented a home as contrasted with owning a home; the nature of the person’s homes in each jurisdiction; whether the home in a jurisdiction is in a more transitory resort area; the location of the person’s personal possessions; the jurisdiction of the person’s driver’s license; the location of the person’s personal business papers (e.g. bank statements); the location of the person’s family and close

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\(^{27}\) I.R.C. § 7701(a)(30)(E).


\(^{29}\) Treas. Reg. § 20.0-1(b)(1); see, e.g., Estate of Paquette v. Comm’r, T.C. Memo. 83-571 (Sept. 15, 1983).

\(^{30}\) I.R.C. § 7701(b)(1).

\(^{31}\) Treas. Reg. § 20.0-1(b)(1).

\(^{32}\) Williamson v. Osenton, 232 U.S. 619, 624 (1914) (citations omitted).
friends and the amount of time spent with them; the location of the person’s place of worship; where the person actually attended worship services; the location of the person’s club memberships and the time spent there; the location of the person’s place of employment; and the location of the person’s business.\(^{33}\)

### III. Expatriation and Taxation

U.S. citizens may lose their citizenship ("expatriation") by performing certain acts voluntarily and with intention to relinquish citizenship.\(^{34}\) One such act is obtaining naturalization, after attaining the age of 18, in a foreign state. Other acts include taking an oath of allegiance to a foreign state; serving in the armed forces of a foreign state engaged in hostilities against the United States; serving as a commissioned or non-commissioned officer in the armed forces of a foreign state; accepting employment with a foreign government if employment is only available to nationals of the foreign state; accepting employment with a foreign government if an oath of allegiance to the foreign government is required in accepting the employment position; making a formal renunciation of citizenship before a U.S. foreign service officer abroad, in the form required by the Secretary of State; making a formal written renunciation in the United States in the form required by the Attorney General, when the United States is in a state of war and the Attorney General approves the renunciation; and committing treason against the United States or attempting to overthrow the United States government, upon conviction therefor. Additionally, U.S. naturalization may be revoked by a court decree and a person lose U.S. citizenship from a prior naturalization ("denaturalization") if there was fraud in the naturalization process or concealment of information or if the person acquired permanent residency in a foreign state within one year after naturalization in the United States.\(^{35}\) This latter act is subject to a statutory presumption that the naturalized person did not intend to reside permanently in the United States and therefore should be denaturalized.

Generally, the HEART Act, enacted by Congress in 2008, created a mark-to-market departure, or exit tax on the expatriate’s worldwide assets effective for individuals whose expatriation date is on or after June 17, 2008.\(^{36}\) Section 877A treats all property as if it were sold for its fair market value by the covered expatriate on the day before the expatriation date, thus resulting in an immediate capital gains tax on the deemed sale. The property taxed is the property that would be taxable as part of the expatriate’s gross estate for federal estate tax purposes as if

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\(^{34}\) INA § 349; 8 U.S.C. § 1481(a)(2)–(a)(7).

\(^{35}\) 8 U.S.C. § 1451.

\(^{36}\) Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. No. 110-245, § 301(a), (g)(1) (the "Heroes Act" or the "HEART Act").
he or she had died on the day before the expatriation date. 37 The exit tax applies to any portion of a trust for which a covered expatriate is treated as the owner under the grantor trust rules as determined on the day before the expatriation date. 38 A “covered expatriate” is defined under Code section 877A as any expatriate having (i) as average annual income tax liability of more than $147,000 for the five taxable years ending before expatriation,39 having a net worth of $2,000,000 on the date of expatriation, or failing to certify compliance with the Code for the five preceding taxable years or to submit evidence of this compliance as required by the Service. Under Code section 877A(a)(3) a portion of gain is excluded. See Notice 2009-85 for a discussion of the allocation of the section 877(a)(3) exclusion amount among all built-in gain property. The exclusion amount is $636,000 in 2011. According to 2009-45 I.R.B. 589, a covered expatriate files a dual status income tax return by filing Form 1040NR and attaches a Form 1040 as a schedule. Thereafter the covered expatriate files Form 1040 NR and Form 8854. The U.S. Department of Treasury’s model income tax treaty includes a savings clause that permits the United States to tax former citizens pursuant to section 877. Accordingly, neither the HEART Act nor Notice 2009-85 pays any significant attention to coordinating with the provisions of U.S. tax treaties. 40

Prior to the enactment of the HEART Act, the American Jobs Creation Act of 2004 (the “AJCA”) 41 applied a special tax system to covered expatriates who expatriated after June 3, 2004 and before June 17, 2008. The AJCA rules generally apply for the ten-year period following the expatriation date of the individual who expatriated during this time period. During these ten years, the expatriate needs to be mindful of the potential reach of the United States’ taxation system. Ten years of reporting may be required under section 877, whether or not U.S. income tax is actually imposed during the ten-year period. Individuals subject to the ten-year reporting file Form 8854 pursuant to section 6039G. The AJCA reclassifies an individual as a U.S. resident for federal income tax, federal estate tax, federal gift tax, and generation-skipping transfer tax purposes for any calendar year during the ten-year period following expatriation in which the individual is physically present in the United States for more than 30 days. This 30 day period may be extended for an additional 30 days for certain business trips for a qualifying employer and if the individual meets certain tests. If the individual exceeds the allowable 30 days,

37 Notice 2009-85.
39 $147,000 is the 2011 amount. The income tax liability amount is adjusted for inflation each year.
41 P.L. No. 108-357, § 804.
within any year during the ten-year period following expatriation, then that individual is subject to U.S. transfer taxes within that year as if the person were a U.S. citizen.

IV. Titling of Property

An exhaustive discussion of the various issues surrounding different titling of assets is beyond the scope of these materials. This section is intended to highlight a few issues with the most common titling option seen in cross-border asset titling – holding assets individually or as joint tenants with rights of survivorship, as well as issues with trusts. A few of the issues surrounding holding assets in a corporation will also be addressed.

Property in Canada

Subject to “know your client” and anti-money laundering rules, non-residents of Canada may own bank accounts in Canada. If a U.S. person owns such an account or has signature authority on such an account, he or she will be subject to reporting obligations in the United States (discussed below). Canadian provinces and territories also do not restrict foreign ownership of real property in Canada; however, some limit the amount of land that a non-resident may purchase. Alberta, Manitoba, Saskatchewan, and Prince Edward Island, for example, limit land purchases by a non-resident. The options for ownership include (A) direct ownership either (i) solely or (ii) jointly; (B) indirect ownership such as through a corporation (Canadian or non-Canadian), U.S. limited liability company, or partnership; or (C) a trust (Canadian or non-Canadian).

In evaluating the manner of holding title to property in Canada it is important to understand some differences in law from the United States. Quebec’s law partially derives from a civil law system, similar to Louisiana. The other nine provinces and three territories have laws derived from the English common law system. Common law jurisdictions classify property as either real or personal. Quebec classifies property as moveable or immovable. Immovable property includes real property.

Joint tenancy and tenancy in common are two typical forms of joint ownership of property in a common law province or territory. Unlike most jurisdictions in the United States, the interpretation of the titling of property titled as “joint tenants with rights of survivorship” as vesting title in the surviving joint tenant, is not absolute and in some cases the assets may be held by the surviving joint tenant as a constructive trust for the heirs or the beneficiaries of the deceased joint tenant’s Will. Accordingly, in Canadian common law jurisdictions, the actual

42 Partnership ownership will not be addressed due its limited actual use.
intent of the joint tenants may need to be determined.\textsuperscript{43} Common law jurisdictions treat joint tenancy with rights of survivorship as a Will substitute.

Civil law jurisdictions like Quebec generally disregard the survivorship element of joint tenants with rights of survivorship. In civil law jurisdictions delivery may be made at death but the divesting of ownership must occur at the time a gift is made and not be conditioned on a subsequent occurrence like death.\textsuperscript{44} In Quebec, assets titled as joint tenants will be treated as if titled as tenants in common. Furthermore, laws of succession must also be considered. In Quebec, the rights of succession may supersede the rights of the surviving joint tenant.

Notwithstanding the differences in Canadian interpretation as contrasted with United States interpretation, in most Canadian provinces, U.S. citizens who are married and acquire property in Canada will often title the Canadian property as joint tenants with rights of survivorship. Care should be taken to utilize appropriate counsel in the applicable province so that any required showing of intent may be achieved. Titling as joint tenants with rights of survivorship often results in a less efficient tax plan due to the inclusion of value in the property owners’ estates at the time of death; however, the increased Federal exemptions may mitigate this issue for many people. For a U.S. resident of a community property jurisdiction such as Washington, consideration should be given to a property status agreement that provides for a non-pro rata division of the parties’ community property at death – including both probate and non-probate property, with the intention of allocating the Canadian joint tenant with rights of survivorship property to the surviving spouse’s one-half interest in the overall community property. Another issue to be considered for certain assets, is subsection 164(6) of the Canadian Tax Act with respect to the election to carry back of losses on a decedent’s final Canadian tax return. The CRA’s position has been that a surviving joint tenant is not entitled to make such election because the surviving joint tenant is not the same as the decedent.\textsuperscript{45}

In some Canadian provinces, probate fees (which are generally a type of tax) can be substantial. For example, in British Columbia, estates over $50,000 are taxed at a rate of 1.4 percent.\textsuperscript{46}

**Property in the U.S.**

Canadians purchasing property in the United States also often utilize the joint tenants with rights of survivorship form of ownership. Doing so allows the


\textsuperscript{44} For a good discussion of Will substitutes in Canada, see Martin Rochwerg & Leela A. Hemmings, \textit{Will Substitutes in Canada}, 28 Est., Tr. & Pensions J. 50, 58-63 (2008).

\textsuperscript{45} Sherman, \textit{supra}, subsection 164(6) notes.

\textsuperscript{46} Probate Fee Act, S.B.C. 1999, c.4 (Can.).
Canadian to avoid probate, which, Canadian advisors often recommend to their clients because of the probate fees typically seen in Canada (discussed above). Because these probate fees can be avoided by non-probate transfers (e.g., joint tenancies) and because the U.S. estate tax is sometimes equated with a probate fee, some Canadian advisors encourage their Canadian clients (married or not) to hold property in the U.S. as joint tenants with rights of survivorship, believing that this will avoid the estate tax. Instead of avoiding the estate tax, if non-resident aliens hold real property in the U.S. as joint tenants, it will cause the entire value of the real estate (not a percentage interest, as with property held as tenants in common) to be included in each joint tenant’s estate.47

A foreign corporation owned by the Canadian non-resident is the next most common form of ownership; although care must be taken to navigate the Canadian tax issues surrounding shareholder personal benefit. In Canada, if a shareholder receives personal benefit (e.g., uses a vacation home owned by the corporation for personal use), the benefit will be imputed income for Canadian tax purposes. Accordingly, fair market rent typically would need to be paid. Paying rent also may provide some benefit under Code section 2036(a) to avoid the Service attempting to disregard the corporate entity at the time of death of the nonresident alien.48 However, the foreign corporation then may be deemed to be doing business in the United States and subject to tax in the U.S. Furthermore, if the nonresident alien dies and the foreign corporation is inherited by U.S. persons, directly or indirectly, then the corporation becomes a controlled foreign corporation on the thirty-first day after the nonresident alien’s death. The U.S. persons would then be directly taxed on the subpart F income generated by the corporation at ordinary income tax rates.

Considering a Trust

The taxation of trusts in Canada is complex and, other than the few specific situations addressed in these materials, largely beyond the scope of these materials. Generally, the distribution of an asset from a trust to a beneficiary is a deemed disposition and therefore taxable in Canada. Exceptions exist for distributions of capital property to a Canadian resident beneficiary in which case the distribution qualifies as a rollover and the tax is later paid when the beneficiary disposes of the property. Distributions to non-Canadian residents generally result in tax as a deemed disposition at the fair market value; however Canadian real estate distributions may qualify for distribution on a rollover basis. Income distributions generally are taxable. If the beneficiary receiving the distribution is a non-resident of Canada, the trustee must withhold tax. Canada also has a rule commonly called “the 21-Year Rule.” Under subsection 104(4) of the Canadian Tax Act, a trust is deemed to dispose of all of its assets every 21 years and reacquire them at fair market value forcing the realization of capital gains and the payment of the related tax. Accordingly, in practice, instead of long-term dynasty trusts being utilized,

47 I.R.C. § 2040(a).
many trusts are designed to terminate "21 years less one day from the date this trust agreement was executed." For a trust that qualifies as a spousal trust (one of Canada’s special-purpose trusts), the first deemed disposition is upon the death of the spouse and subsequently every 21 years.

Transferring property to a revocable living trust is a deemed disposition for Canadian tax purposes, resulting in the taxation of any deemed gain. Accordingly, for U.S. persons, transferring appreciated Canadian property that would be subject to tax in Canada (such as real estate) to a revocable living trust may cause unintended tax consequences.

V. U.S. Marital Deduction Planning

Classic estate tax planning in the United States takes into account the unlimited marital deduction for transfers to U.S. citizen spouses or trusts that qualify as marital trusts under section 2056. Planning for noncitizen spouses typically includes the creation of a trust that qualifies as a qualified domestic trust ("QDOT") under section 2056A of the Code and section 20.2056A-2 of the Treasury Regulations. In particular, the property must pass from the decedent to (i) a QDOT; (ii) a trust that is reformed to qualify as a QDOT; (iii) the surviving spouse outright who then, prior to the date the estate tax return is filed and during the time that the QDOT election may be made, actually transfers the property to a QDOT or irrevocably assigns the property to a QDOT; or (iv) a plan or other arrangement for annuities that are not assignable or transferable to a QDOT, if the requirements of Treasury Regulations section 20.2056A-4(c) are met (for individual retirement annuities that are nonassignable because of section 408(b)(1) or individual retirement accounts that the surviving spouse elects to treat as nonassignable and therefore eligible for the rules that apply to non-assignable annuities and payments.

Planning for a non-citizen spouse who is a citizen or resident of Canada, and planning for a non-citizen who is a resident of Canada but with assets in the U.S. subject to U.S. estate tax includes options not available in planning for non-citizens of most other countries.49 Treasury Regulations section 20.2056A-1(c) requires the estate to either elect the QDOT provisions or the treaty marital deduction. Protocols to the U.S.-Canada income tax treaty provide some limited relief from estate tax and/or the requirement to utilize a QDOT.50

A unified credit against U.S. estate tax is provided to the estate of the non-citizen decedent who is a resident of Canada at the time of his or her death. The unified credit is the greater of

49 Note that the Protocol to the Convention Between the United States and Germany for the Avoidance of Double Taxation with Respect to Taxes on Estate, Inheritance, and Gifts (1999) adopted a similar approach.
50 The Revised Protocol amended the U.S.-Canada Treaty by adding, in Article 19 of the Revised Protocol, Article XXIX B.
“(a) the amount that bears the same ratio to the credit allowed under the law of the United States to the estate of a citizen of the United States as the value of the part of the individual’s gross estate that at the time of the individual’s death is situated in the United States bears to the value of the individual’s entire gross estate wherever situated; and (b) the unified credit allowed to the estate of a nonresident not a citizen of the United States under the law of the United States.”51

Any credit previously allowed with respect to any gift made by the person during his or her lifetime will result in a reduction of the unified credit available at death.52

The Revised Protocol also allows a marital credit, which is equal to the lesser of (i) the unified credit allowed to the estate and (ii) the amount of the U.S. estate tax that would otherwise be imposed by the United States on the marital deduction property.53 To qualify for the treaty marital credit the following criteria must be satisfied:

(i) The decedent was at the time of death a citizen of the United States or a resident of Canada or the United States;
(ii) The surviving spouse was at the time of the decedent’s death a resident of either Canada or the United States;
(iii) If both the decedent and the surviving spouse were residents of the United States at the time of the decedent’s death, one or both was a citizen of Canada; and
(iv) The personal representative of the estate elects the benefits of the treaty and irrevocably waives the right to make the QTIP and QDOT elections on a U.S. Federal estate tax return filed by the date on which a QDOT election could be made.54

When the decedent is a resident of the United States immediately before his or her death, the Treaty also provides that for purposes of subsection 70(6) of the Canadian Tax Act, that both the decedent and the decedent’s spouse will be deemed to have been resident in Canada immediately before the decedent’s death.55

One issue that has been raised is whether, under the Treaty, a Canadian resident could take advantage of the portability made available to U.S. citizens under section 2010(c) of the Code. The Treaty allows Canadians to take a “unified credit” equal to a percentage of the credit allowed a U.S. citizen or domicile.56 The Code,

51 U.S.-Canada Treaty, Article XXIX B(2).
52 U.S.-Canada Treaty, Article XXIX B(2).
53 U.S.-Canada Treaty, Article XXIX B(3), B(4).
54 U.S.-Canada Treaty, Article XXIX B(3).
55 U.S.-Canada Treaty, Article XXIX B(5).
56 U.S.-Canada Treaty, Article XXIX B(2).
which anticipates the treaty increase for the unified credit, provides that the credit is to be calculated by adjusting the credit allowed to citizens and domiciles under Code section 2010(c).\textsuperscript{57}

Section 2010(c) of the Code is the provision that provides the applicable credit amount, which now includes both the basic exclusion amount and the “Deceased Spousal Unused Exclusion Amount,” the portability provision.\textsuperscript{58} Since Canadians may take a percentage of the applicable exclusion amount and since the applicable exclusion amount includes portability, some practitioners believe that Canadians are entitled to portability, although they caution that portability is only available when an estate tax return is filed for the deceased spouse in the United States.

VI. Canadian Spousal Exemption Planning

In Canada, a taxpayer is deemed to dispose, at fair market value, of all taxable Canadian property immediately before death. Transfers to spouses or qualifying spousal trusts qualify for deferral of the tax but transfers to non-spouses and non-qualifying trusts trigger the tax. Sections 104 through 108 of the Canadian Tax Act govern taxation of trusts and their beneficiaries. Section 94 of the Canadian Tax Act deals with the taxation of foreign trusts with Canadian beneficiaries. A testamentary trust is taxed at the graduated marginal rates applicable to individuals while an inter vivos trust is taxed at the top individual tax rate.\textsuperscript{59} Generally, at the time of transfer to a trust, the taxpayer is deemed to have disposed of the property. Thus, a transfer by a U.S. person to a classic revocable living trust can cause taxation in Canada even though it wouldn’t typically cause taxation in the United States. Holding the Canadian property individually and allowing it to pass to the revocable living trust via the pour-over Will could be considered as a strategy; however, doing so is risky for several reasons. The trust is a separate taxpayer in Canada so the foreign death tax credit under the Treaty may not be available. The pour-over Will may be without legal effect in Canada because the revocable living trust to which it pours may be amended without the formalities of a Will.\textsuperscript{60}

Furthermore, if a marital trust designed to qualify for the marital deduction in the United States is included in the estate plan, a Will is the preferred estate planning document, rather than a revocable living trust. A testamentary marital trust will typically meet the requirements for a tax-deferred rollover to a testamentary spousal trust in Canada while a marital trust contained in a revocable living trust will not. Generally, the property passes to the testamentary spousal trust at the adjusted cost basis. The Canadian gain is taxed at the time the trustee

\textsuperscript{57} I.R.C. § 2101(b)(3)(A).
\textsuperscript{58} I.R.C. § 2010(c)(2).
\textsuperscript{59} Attribution rules also need to be considered in trust tax planning in Canada. See, e.g., Canadian Tax Act sections 75(2), and 74.1.
disposes of the property or at the time the surviving spouse dies, whichever is earlier. While subsection 70(6) of the Canadian Tax Act only allows this tax deferred rollover treatment to transfers by a Canadian resident to a Canadian resident spousal exemption trust, the Treaty provides the benefit to U.S. residents and U.S. trustees.61

VII. Canadian Immigration Trusts

Given the continued favorable income tax rates in the United States, U.S. trusts structured as Canadian immigration trusts continue to be desirable to United States citizens moving to Canada. Additionally, the continued depressed real estate market in the United States results in an environment that may be favorable for immigration trusts for persons who may wish to sell real estate several years after moving to Canada rather than receiving the adjusted cost basis for that asset at the fair market value at the date the grantor becomes resident in Canada.

An immigration trust is a trust that is created outside of Canada for the benefit of a new immigrant to Canada. For purposes of these materials focusing on United States and Canada cross-border planning, I will assume that the immigration trust will be created in the United States by a U.S. grantor. For up to 60 months the grantor is taxed in the U.S. at the rates in effect in the United States rather than being taxed in Canada on the income and capital gains rates in effect in Canada and its provinces and territories, notwithstanding that the grantor resides in Canada and is otherwise subject to Canadian income tax.62 Immigration trusts are exempted from Canada’s general taxation of offshore trusts during this time period.

Beneficiary, Trustee, Trust Protector, and Trust Structure

To qualify as a Canadian immigration trust, the trust must not be resident in Canada. In order to determine whether a trust is resident in Canada, several factors must be considered.63 The identity and residency of the grantor-beneficiary; the identity, residency, and family relationship of the trustee; the identity, residency, and any family relationship of the trust protector; the powers given to the trustee to determine matters within the discretion of the trustee; the place where the administration of the trust is carried on; the records of the trustee in administering the trust; the situs of the assets held in trust; the existence or absence of a “guiding mind and will” which directs (or could direct) the trustee; and the powers given to the grantor.64 The trust will need to be structured as a grantor trust pursuant to section 671 of the Code in order to continue to be taxed on the grantor’s individual

61 U.S.-Canada Treaty, Article XXIX B(5); CRA Interpretation Bulletin IT-305R4, October 30, 1996, ¶ 33.
62 Canadian Tax Act paragraph 94(1)(b).
64 Garron Family Trust v. The Queen, 2009 T.C.C. 450; Antle v. The Queen, 2009 T.C.C. 465.
U.S. income tax return; however, several of the powers traditionally retained by grantors of U.S. revocable living trusts must not be retained or the trust will not qualify as an immigration trust in Canada. These issues will be discussed below.

Grantor-Beneficiary. Under Canadian law, the trust may only have one beneficiary (the sole grantor); however, in community property jurisdictions like Washington, practitioners routinely draft joint trusts for which both the husband and wife are grantors and beneficiaries in order to preserve the community property status of the assets held in trust. To the author’s knowledge this has not been challenged in Canada in circumstances where the trust is clear that the ownership is for community property interests. The grantor-beneficiary must not be a resident of Canada at the time the trust is created. The grantor-beneficiary must not have already utilized his or her 60-month residency in Canada. Practically speaking a practitioner determines if his or her client has ever resided in Canada, even as a young child. If a person has resided in Canada previously, the prior residency will apply toward the available 60-month exemption from Canadian tax. For example, if the person resided in Canada for ten months as a child, then the person has 50 remaining months available for the maximum term of a Canadian immigration trust. Residency in Canada is objectively determined as being physically present for more than 182 days in any calendar year.  

Trustee. The trustee of the immigration trust must be a non-Canadian and not ever reside in Canada. The trust should include a provision that in the event the trustee becomes a resident of Canada that the trustee is deemed to have resigned. The grantor may not be given the power to remove and replace the trustee as would commonly be given in the United States. The trust will often provide for a trust protector (who also must not be a Canadian or reside in Canada). The trust protector has the power to remove and replace the trustee. Neither the trust protector nor the trustee may be a family member of the grantor. The trust should provide that if the trust protector becomes resident in Canada that he or she is deemed to have resigned. The trust typically provides for the automatic change of trustee to the grantor at the termination date.

Assets of the Trust

The grantor should hold one year’s worth of liquid living expenses outside of the trust. Generally, most or all other non-Canadian assets are held within the trust. Examples of assets include homes in the United States, stocks, bonds, mutual funds, and any other non-Canadian assets. A U.S. mutual fund that owns stock in a Canadian company is a U.S. asset for purposes of the trust.

65 Canadian Tax Act subsections 2(1), 2(3).
Canadian source investments should not be transferred to the immigration trust. Dividends from Canadian public companies are taxed at preferential rates\textsuperscript{67} in Canada. If the grantor has no other income in Canada than income from Canadian dividends, the grantor may receive approximately $50,000 of dividends free of Canadian tax.

**Tax Savings and Taxation of the Trust**

The realized capital gains rate in the United States is currently lower than the Canadian rate. Realized Canadian capital gains tax rates of combined Provincial and federal rates range from 19.5% to 26.5% (e.g. British Columbia’s combined capital gain rate is 22.85%). The capital gains exemption for a portion of the gain on a sale of a U.S. principal residence in the United States may be available in the United States for the grantor but that same exemption is not available in Canada. Furthermore, a capital loss carry forward may still be used and not lost upon immigration to Canada.

Municipal bonds generate tax-free income in the United States but in Canada the bonds are taxed at rates up to 29% at the federal level and to top provincial rates ranging from 10% to 24% (for a combined rate in British Columbia of 43.7%).\textsuperscript{68} As an example of the Canadian tax system, consider the Canadian federal rate structure that taxes at a 15% rate on the first $41,544 of taxable income, plus 22% on the next $41,544 of taxable income (the portion between $41,544 and $83,088), plus 26% on the next $45,712 of taxable income (the portion between $83,088 and $128,800), plus 29% of taxable income over $128,800. If the person is subject to British Columbia tax, the rates are 5.06% on the first $36,146 of taxable income, plus\textsuperscript{7} 7.7% on the next $36,147, plus 10.5% on the next $10,708, plus\textsuperscript{12} 12.29% on the next $17,786, plus\textsuperscript{14} 14.7% on the amount over $100,787.\textsuperscript{69}

The cost basis for Canadian tax purposes will be equal to the fair market value of the assets on the date distributed to the beneficiary. If the assets remain in the immigration trust for the entire term of the trust then there is potential for a step-up in basis to the value at the date the trust terminates.

Distributions of income to the beneficiaries who are Canadian residents will be subject to tax in Canada while distributions of principal will be tax-free. This is the reason that the beneficiaries should withhold approximately one year’s worth of living expenses from the trust at the time of funding. This allows for the trustee to invest the trust assets and appoint the undistributed trust income to principal at the

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\textsuperscript{67} See, e.g., Canadian Tax Act subsection 185.1(1) (dividends taxed at 20 percent).

\textsuperscript{68} Canadian Tax Act subsection 117(2); CRA, *What are the income rates in Canada in 2011?*, http://www.cra-arc.gc.ca/tx/ndvds/fq/txrts-eng.html (modified Mar. 23, 2011) (examples of provincial rates include Quebec (up to 24%); British Columbia (up to 14.7%); and Alberta (up to 10%)).

\textsuperscript{69} CRA, *What are the income rates in Canada in 2011?*, supra.
end of each year (discussed below). Annual reporting in Canada with respect to the trust is made along with the beneficiary’s Canadian income tax return.  

**Structure and Administration of the Trust**

The trust must be validly created under applicable state law. Notarization of the trust instrument, while not required in Washington, is evidence of the timely creation of the trust. Notarization is also evidence of the timeliness of the transfer of assets to the trustee.

Distributions of principal and income should both be discretionary. Principal should be defined to mean capital under the Canadian tax laws. The trustee should document decisions to make distributions and should also document whether the distribution is from principal or income. The trust should provide that annually all undistributed income is “appointed” (added) to principal. Additionally, the trustee must document, annually, in trustee minutes, the actual appointment of the undistributed income to principal. The trust should provide that the beneficiaries may use any real property; however, it should also provide that the beneficiaries must pay the operating expenses of any real property that is used or the beneficiary may have imputed income for Canadian tax purposes.

In order to qualify as a grantor trust pursuant to section 671 of the Code without the grantor being the “guiding mind and will” under Canadian law (which would result in the trust being taxed in Canada) the trust is usually structured as a trust that the grantor may revoke. Although the power to revoke the trust is not specifically allowed under the Canadian tax regime, this power has not been challenged. As a matter of policy, this makes sense since in revoking the trust the grantor would immediately subject the assets to taxation under the Canadian tax system. However, the grantor may not be given a power to appoint the trust assets (normally given under section 674 of the Code). Furthermore, the grantor may not be given the following powers which are often reserved to the grantor under Code section 675: (i) to deal with trust assets for less than adequate and full consideration; (ii) to borrow trust assets without adequate interest and security (and actually, for Canadian tax purposes the trust should prohibit the grantor from borrowing trust assets); (iii) to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (iv) to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; and (v) to reacquire the trust

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70 Form T1141 is filed if any transfers are made to the trust, and Form T1142 is filed if any distributions are received from the trust.
72 I.R.C. § 676.
corpus by substituting other property of an equivalent value. In addition to these powers, which must not be included in the trust, for Canadian tax purposes the trust should not allow the grantor to borrow trust assets or to vote, direct the vote, or control the investment or reinvestment of any trust assets. The trust must give the trustee the power to enter into contracts and to otherwise manage all of the assets of the trust.

Evidence of the management and control of the trust may be scrutinized by CRA. Timely and legally effective retitling of assets in the name of the trustee of the trust is critical. The actual control over the books and records of the trust assets must be in the hands of the trustee and must be handled outside of Canada. For example, investment account statements should be sent to the trustee at the trustee’s U.S. address. A copy may be sent to the beneficiary but the titling on the account and the statements should reflect the name and location of the trustee. The trustee must maintain records of the decision process of the trustee. These records may be needed on examination. Trustees of these trusts typically take minutes of meetings or record the decisions on a dated consent document. There should be evidence of the trustee taking the position as a serious obligation. The trustee’s communications with advisors and the beneficiary in order to understand what is in the beneficiary’s best interest may be evidence of this. The trustee’s experience and expertise may be a factor considered on examination. The trustee may be less experienced if the trustee seeks appropriate guidance and acts in good faith. Any evidence that shows that the grantor is not the “guiding mind and will” of the trustee should be retained as it may be needed on examination.

Termination of the Trust. The termination date is written to apply the grantor’s available sheltering time period to the term of the trust and then often directs that the assets will be distributed to the grantor. If the grantor dies prior to the termination date, the trust should be written to terminate. The grantor should consider updates to his or her Wills and other estate planning documents in light of the anticipated consequences of receiving assets from the immigration trust.

VIII. Foreign Bank Account Reporting: Form TDF 90-22.1, the FBAR

I. FBAR: Who and What


1. The statute provides:

“(a) Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or
a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency. The records and reports shall contain the following information in the way and to the extent the Secretary prescribes:

“(1) the identity and address of participants in a transaction or relationship.
“(2) the legal capacity in which a participant is acting.
“(3) the identity of real parties in interest.
“(4) a description of the transaction.

“(b) The Secretary may prescribe--

“(1) a reasonable classification of persons subject to or exempt from a requirement under this section or a regulation under this section;
“(2) a foreign country to which a requirement or a regulation under this section applies if the Secretary decides applying the requirement or regulation to all foreign countries is unnecessary or undesirable;
“(3) the magnitude of transactions subject to a requirement or a regulation under this section;
“(4) the kind of transaction subject to or exempt from a requirement or a regulation under this section; and
“(5) other matters the Secretary considers necessary to carry out this section or a regulation under this section.

“(c) A person shall be required to disclose a record required to be kept under this section or under a regulation under this section only as required by law.”

2. Note that the FBAR is not part of the Code.
   a. Statutory authority for the FBAR is vested in the Financial Criminal Enforcement Network (“FinCEN”), and not the Service. However, FinCEN and the Service have entered into an interagency agreement providing that the Service administers the FBAR. See, e.g., IR-2003-48 (Apr. 10, 2003), http://www.irs.gov/newsroom/article/0,,id=108790,00.html (describing “a memorandum of agreement under which FinCEN
delegates its enforcement authority for Foreign Bank and Financial Account reporting to the IRS”).

b. The Code does not apply to the FBAR. For example, pursuant to I.R.C. § 7502, the “mailbox rule” applies to tax forms. The FBAR instructions provide: “The FBAR must be received by the Department of the Treasury on or before June 30th of the year immediately following the calendar year being reported.” FBAR at 6 (emphasis in original).


2. The general filing obligation applies to “[e]ach United States person having a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country.” 31 C.F.R. § 1010.350(a).

C. United States Person. 31 C.F.R. § 1010.350(b).

1. Individuals:

   a. U.S. citizens and

   b. Resident aliens, as defined in I.R.C. § 7701(b): green card holders and persons treated as substantially present.

   c. Basically, any individual treated as a U.S. person for tax purposes, except that when determining whether a person is a “resident alien,” the United States includes possessions and territories other than Washington, D.C.

2. Entities: “An entity, including but not limited to, a corporation, partnership, trust, or limited liability company created, organized, or formed under the laws of the United States, any State, the District of Columbia, the Territories and Insular Possessions of the United States, or the Indian Tribes.” 31 C.F.R. § 1010.350(b)(3).

   a. A single-member LLC treated as a disregarded entity for tax purposes is a U.S. person that must file an FBAR.

   b. Broader than the Code definition, in that it includes “the Territories and Insular Possessions of the United States, or the Indian Tribes.” These areas are not included in the I.R.C. § 7701(a)(9) definition of the United States.

D. Financial Interest. 31 C.F.R. § 1010.350(e). A person is treated as having a financial interest in a foreign account pursuant to either of two tests:

1. The Direct Owner Test: “A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which he is the owner of record or has legal title whether the account is maintained for his own benefit or for the benefit of others.” 31 C.F.R. § 1010.350(e)(1).

2. The Indirect Owner Test: “A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which the owner of record or holder of legal title is” a certain type of person. 31 C.F.R. § 1010.350(e)(2):
a. An agent: “A person acting as an agent, nominee, attorney or in some other capacity on behalf of the United States person with respect to the account.” 31 C.F.R. § 1010.350(e)(2)(i).

b. A controlled corporation: “A corporation in which the United States person owns directly or indirectly more than 50 percent of the voting power or the total value of the shares.” 31 C.F.R. § 1010.350(e)(2)(ii).

c. A controlled partnership: “[A] partnership in which the United States person owns directly or indirectly more than 50 percent of the interest in profits or capital.” 31 C.F.R. § 1010.350(e)(2)(ii).

d. A controlled other entity: “[A]ny other entity (other than an entity in paragraphs (e)(2)(iii) through (iv) of this section [related to trusts]) in which the United States person owns directly or indirectly more than 50 percent of the voting power, total value of the equity interest or assets, or interest in profits.” 31 C.F.R. § 1010.350(e)(2)(ii).

e. A grantor trust: “A trust, if the United States person is the trust grantor and has an ownership interest in the trust for United States Federal tax purposes.” 31 C.F.R. § 1010.350(e)(2)(iii).

f. A certain other trust: “A trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.” 31 C.F.R. § 1010.350(e)(2)(iv).

3. Issue Related to “custodial accounts.”

a. Before the adoption of final regulations, there was significant concern over a situation in which a U.S. person would have a U.S. custodial bank account and the U.S. custodial bank would then establish a foreign bank account to hold some or all of the assets of the custodial account. A question arose as to whether the U.S. person had a financial interest in the foreign account in which the custodial bank made the investment.

b. The preamble to the FBAR regulations directly addresses this issue:

“FinCEN received a number of comments asking for clarification regarding specific custodial arrangements. Commenters explained that in some cases a United States person may have an account with a financial institution located in the United States, such as a bank. According to the commenters, that U.S. bank may act as a global custodian and hold the person’s assets outside the United States. In many cases, the custody bank creates pooled cash and securities accounts in the non-U.S. market to hold the assets of multiple investors. These accounts, commonly called omnibus accounts, are in the name of the global custodian. Typically, the U.S. customer does not have any legal rights in the omnibus account and can only access their holdings outside of
the United States through the U.S. global custodian bank. FinCEN wishes to clarify that in this situation, the U.S. customer would not have to file an FBAR with respect to assets held in the omnibus account and maintained by the global custodian. In this situation, the U.S. customer maintains an account with a financial institution located in the United States.” 76 Fed. Reg. at 10,235 (emphasis added).

c. This raises an interesting issue with respect to the Indirect Owner Test. It must be the case that the custodial bank is not “[a] person acting as an agent, nominee, attorney or in some other capacity on behalf of the United States person with respect to the account.” Id. at 10,246. It could be that “agent,” as used in the Indirect Owner Test, is limited to roles similar to those of a “nominee” or “attorney.” However, the use of “or in some other capacity” would seem to indicate a broad definition of “agent.” More likely, the fact that the custodial bank is taking actions that are part of its regular trade or business indicates that the custodial bank’s actions are on its own behalf, and not on behalf of its U.S. customer.

E. Signature or Other Authority. 31 C.F.R. § 1010.350(f).

1. “Signature or other authority means the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained.” Id. (emphasis added).

2. Direct communication with the foreign financial institution is necessary. For example, in the custodial bank context, a U.S. person does not have signature authority over foreign accounts if the U.S. person only can communicate with the U.S. custodial bank concerning the disposition of the foreign accounts.

3. In addition, there are a number of exceptions for U.S. persons that otherwise would be treated as having signature authority. See 31 C.F.R. § 1010.350(f)(2).

F. A Bank, Securities or Other Financial Account. 31 C.F.R. § 1010.350(c).


2. Securities Account: “The term ‘securities account’ means an account with a person engaged in the business of buying, selling, holding or trading stock or other securities.” 31 C.F.R. § 1010.350(c)(2).

3. Other Financial Account: An “other financial account” is an account with any of the following:

a. “[A] person that is in the business of accepting deposits as a financial agency[.]” 31 C.F.R. § 1010.350(c)(3)(i).
b. “[A]n insurance or annuity policy with a cash value[]” 31 C.F.R. § 1010.350(c)(3)(ii).
c. “[A] person that acts as a broker or dealer for futures or options transactions in any commodity on or subject to the rules of a commodity exchange or association[]” 31 C.F.R. § 1010.350(c)(3)(iii).
d. “A mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions[]” 31 C.F.R. § 1010.350(c)(3)(iv)(A).

4. Before the adoption of final regulations, there was significant concern over whether an FBAR obligation arose for certain foreign pooled funds, such as foreign hedge funds or private equity funds. These types of investments generally are available only through a privately placed offering, and are not available to the general public. Currently, there is no FBAR filing obligation for these investments. Note, however, that the final rules include “other investment fund” as a category of “other financial account,” but reserve on providing a definition.

G. When to File.
1. General Rule: “The FBAR must be received by the Department of the Treasury on or before June 30th of the year immediately following the calendar year being reported. The June 30th filing date may not be extended.” FBAR at 6 (emphasis omitted). FinCEN and the Service take the position that the “mailbox rule” does not apply. In fact, requests that the “mailbox rule” be incorporated into the final regulations were met with silence.
2. Because of general confusion about the FBAR, FinCEN and the Service created extensions for 2009 and earlier years:
   b. In certain circumstances, FBARs for 2003-2009 could have been filed by September 9, 2011. See FAQ 17 of 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, available at http://www.irs.gov/businesses/international/article/0,,id=235699,00.html. This initiative is referred to as the “2011 OVDI.”

H. Where to File.
1. The FBAR is not included with a tax return.
2. Instead, it is filed with the Department of the Treasury at Post Office Box 32621, Detroit, MI 48232-0621.
3. Because the Service takes the position that the “mailbox rule” does not apply, an express mailing address also is provided: IRS Enterprise Computing Center, ATTN: CTR Operations Mailroom, 4th Floor, 985 Michigan Avenue, Detroit, MI 48226.
4. The FBAR also can be hand delivered to any IRS local office for forwarding to Detroit.
a. Even if hand delivering the FBAR, allow sufficient time for forwarding to Michigan.
b. Hand delivery and receiving a time-stamped copy is not an effective method for filing, compared to a mailing that can be tracked.
c. Nonetheless, the fact that an FBAR can be delivered to any local office of the IRS gives the Service additional venue options for litigating late or unfiled FBAR issues. See United States v. Bradley, 644 F.3d 1213 (11th Cir. 2011).

I. Threshold for Filing.
   1. The aggregate value of financial accounts outside of the U.S. if at any time in a calendar year the value exceeds $10,000 USD using the currency conversion rate for December 31 of the calendar year.
   2. The value includes the cash value of insurance policies among other securities and financial account definitions.
   3. The accounts are those held directly and indirectly.
      a. The accounts are all aggregated
      b. The aggregated accounts include those for which the US person has signature authority.


   A. Prior to 2004, a penalty for a late-filed or an unfiled FBAR applied only if the U.S. person acted willfully.
      1. Willfulness generally is difficult for the Service to establish, especially for a form like the FBAR, which is not well known.
      2. Schedule B of Form 1040 includes a question asking if the filer has a foreign bank account, and references the FBAR.
      3. The Service generally takes the position that answering “no” to that question when the filer does have a foreign bank account is an act of willfulness giving rise to penalties for willfully failing to file an FBAR. See I.R.M. § 4.26.16.4.5.3(8)(A) (“A person admits knowledge of, and fails to answer, a question concerning signature authority over foreign bank accounts on Schedule B of his income tax return. When asked, the person does not provide a reasonable explanation for failing to answer the Schedule B question and for failing to file the FBAR. A determination that the violation was willful likely would be appropriate in this case.”).


      1. The $10,000 penalty does not apply if:
         a. the violation was due to reasonable cause, and
         b. “the amount of the transaction or the balance in the account at the time of the transaction was properly reported.”
      2. The phrasing of the second prong is unclear.
a. However, it appears that a taxpayer must properly report for the appropriate tax year income from the foreign account on the taxpayer’s federal income tax return to satisfy this second prong.  
b. This interpretation is consistent with the guidance provided in FAQ 17 of the 2011 OVDI for making a penalty-free late filing of the FBAR.

3. The reasonable cause exception requires reporting that is “proper,” not reporting that is “proper and timely.” This raises the question of whether reporting interest income from a foreign bank account on a late original income tax return or an amended income return constitutes “proper” reporting, even though the reporting is untimely.

   1. Congress also substantially increased the penalty for a willful failure to file in 2004.
   2. The penalty equals the greater of:
      a. $100,000, or
      b. 50 percent of the account balance.
   3. When a taxpayer willfully fails to file an FBAR for several years, the Service applies the 50 percent penalty to the account balance in each year, without reduction for penalty imposed for any prior year.
      a. For example, if a taxpayer willfully failed to file an FBAR for 2008, 2009 and 2010 and the highest balance in the account was $1,000,000 each year, the Service will assert a penalty of $1,500,000 – more than the entire amount ever in the account.
      b. One could argue that the penalty should be $875,000: $500,000 for 2008, which should be deemed to reduce the account balance to $500,000; $250,000 for 2009, which should be deemed to reduce the account balance to $250,000; and $125,000 for 2010.

E. Criminal penalties also apply. See 31 U.S.C. § 5322.


A. The 2004 creation of a $10,000 penalty for a non-willful failure to file was somewhat of a trap for the unwary.
   1. Many, if not most, taxpayers subject to the filing obligation did not know about the FBAR.
   2. There are a variety of reasons other than tax evasion that people failed to report income (generally, interest income) from their accounts:
      a. Not knowing that the United States taxes a U.S. person on worldwide income, regardless of source.
      b. Being subject to foreign tax on the interest where the U.S. foreign tax credit is more than the U.S. tax liability.
      c. No regular account statements or a Form 1099 to remind the taxpayer that interest income was earned.
d. A belief that a foreign bank account is like an investment in stock: no reporting obligation or tax liability arises until the person “cashes out.”

e. The taxpayer resides in another country, has no tax liability for earned income because of the I.R.C. § 911 exclusion or foreign tax credits, and has no tax liability for investment income because the investment income is less than the standard deduction/personal exemption or is completely offset by the amount of tax credits.

3. None of these reasons are valid or excuse non-compliance. Nonetheless, they potentially explain the lack of reporting on a tax return, which generally disqualifies the taxpayer from the reasonable cause exception.

B. The FBAR and related penalties started becoming a major area of discussion in the tax world in 2009. For example, a search of “FBAR” on Tax Notes Today reveals 20 articles in 2008 (11 in 2007 and 13 in 2006). In 2009, there were 187 articles. By this time, the $10,000 per year minimum penalty for non-compliance for a person with an account since 2004 was $50,000 or $60,000.

C. In 2009, the Service created an initiative to allow non-filers to get into compliance. The 2009 program ended on October 15, 2009. On February 8, 2011, the Service announced the 2011 OVDI. The deadline to participate in that program ended on September 9, 2011 (after an extension due to Hurricane Irene).

D. The 2011 OVDI.

1. This outline only briefly summarizes certain aspects of the 2011 OVDI because the program has ended.

2. The 2011 OVDI primarily concerned the process for making a voluntary disclosure of unfiled FBARs and resolving all possible civil and criminal penalties. Participants:

a. Paid an FBAR penalty of 25 percent of the highest account balance in any year since 2003 for which an FBAR was not filed. See FAQ 7. The penalty was reduced to 12.5 percent or 5 percent in certain circumstances. See FAQs 53, 52. A participant could opt out of the penalty portion of the 2011 OVDI (e.g., if the penalty exceeded the $10,000 per year non-willful failure to file penalty and the participant was confident that willful penalties did not apply). See FAQ 51.1. The Service warned, however, that the Service would not be precluded from asserting that a person that opted out had willfully failed to timely file the FBAR. See FAQs 51.2, 51.3.

b. Paid income tax, penalty and interest related to unreported income from the account.

c. Provided various documents about the foreign accounts and other procedural documents.

3. In FAQ 17, the Service also provided relief that allowed a person to make a penalty-free so-called “quiet” disclosure of unfiled FBARs. This relief applied to a person qualifying for the statutory reasonable cause exception, except that it was not necessary to demonstrate reasonable
cause. That is, the relief applied to a person that reported all income from the foreign account and simply failed to file an FBAR.

a. The Service phrasing of the relief may have caused the relief to apply to a broader category of persons.

b. FAQ 17 focuses on the taxpayer’s tax liability, and uses the term "taxable income," rather than "gross income" or "items of taxable income."

c. In FAQ 17, the Service stated, in part, that it would “not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities.”

d. This appears to indicate that a taxpayer with no unreported taxable income and no underreported tax liabilities qualifies for the relief, even if the taxpayer never reported gross income from the foreign account. For example, a person with unreported interest income and unreported offsetting deductions could take the position that FAQ 17 applied. It is unclear whether the Service would agree.

e. The Service has taken the position that FAQ 17 does not apply to a person with unreported taxable income and an unreported foreign tax credit sufficient to offset the U.S. tax liability arising from the unreported income. See FAQ 51.1. It appears that such a person did not qualify for FAQ 17 relief because, although the person did not underreport tax liability, the person had unreported taxable income.

IV. Addressing Past Non-Compliance After the 2011 OVDI.

A. There probably are a significant number of taxpayers with unfiled FBARs who still do not know about the FBAR.

B. The issue arises as to how to advise these taxpayers absent another offshore voluntary disclosure initiative.

C. Regular Voluntary Disclosure.
   1. Even without a formal initiative, a traditional voluntary disclosure is possible.
   2. A taxpayer making a regular voluntary disclosure will likely face the $10,000 per year penalty. Although a willful failure to file penalty is possible, the taxpayer voluntarily coming forward may make it unlikely that the Service will assert willfulness.

D. Quiet Disclosure.
   1. As described above, the reasonable cause exception appears to require that all income from an account be “properly” reported. The law is silent on whether, to be proper, reporting of the income has to be timely.
   2. Accordingly, a taxpayer might be able to:
      a. File amended income tax returns reporting all income from the account,
      b. File late FBARs, and
      c. Take the position that the reasonable cause exception applies.
   3. Not surprisingly, the Service is against people doing this.
a. Prior to the 2009 and 2011 initiative, many taxpayers apparently made this type of quiet disclosure.
b. The Service has warned that these taxpayers “should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.” FAQ 15.
c. Further, the Service claims that it is actively searching out these filers. See FAQ 16.

4. Accordingly, there are significant risks to a taxpayer making this type of quiet disclosure.

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