

JANUARY 31, 2025

Selected US Tax Developments

Authors: [Jonathan M. Rhein](#) and [Rhonda Rudick](#)

First published by the Canadian Tax Foundation in (2024) 72:4 *Canadian Tax Journal*.

Treaty Provides Unique Benefits To Canadians Migrating To The United States

Canadians who emigrate to the United States or elsewhere face many decisions and considerations associated with departure, but careful tax planning should not be an afterthought. When an individual ceases to be resident in Canada, the individual is deemed to dispose of all of the individual's property (subject to certain listed exceptions) for fair market value proceeds immediately before departure and is required to pay Canada's departure tax on the deemed disposition. This tax presents an opportunity for the individual to step up the US tax basis in the property under the US-Canada treaty.

Introduction

Canada's departure tax can be onerous, so it is important for Canadian emigrants to coordinate Canadian and US tax consequences. Planning opportunities exist in connection with the election available under article XIII(7) of the US-Canada treaty.¹ This election (a "treaty election") permits an individual who is subject to the departure tax to elect to be treated for US tax purposes as if the individual had, immediately before departure from Canada, sold and repurchased the property that is deemed disposed of and taxed for Canadian tax purposes for its fair market value immediately before that time.² Many Canadian emigrants who are moving to the United States would be well advised to make a treaty election, and tax advisers should be aware of the consequences of making the election so that they can optimize their clients' future US tax position. This article discusses a few planning techniques, but each situation is unique and should be considered on a case-by-case basis.

Discussion

Canada's departure tax requires a Canadian-resident individual who becomes a nonresident to pay income tax on all of the individual's property as if the property were sold for its fair market value at the time of departure, subject to certain exceptions.³ The tax is generally due on April 30 of the year following departure, but the tax can be deferred if the individual makes an election and posts acceptable security to the Canada Revenue Agency.⁴

When a Canadian-resident individual is treated as disposing of property and is subject to Canadian tax on the disposition, the US-Canada treaty permits the individual to make a treaty election.⁵ The election causes the US tax basis in all of the individual's assets to be "stepped up" to the assets' fair market value, generally free of US tax, except with respect to US real estate or other assets the sale of which would produce US-source income (discussed below). Consistent with one of the purposes of the US-Canada treaty, this basis step-up ensures that the individual will not be taxed twice on the same gain, first by Canada and again by the United States.⁶ This is a valuable benefit, unique to the US-Canada treaty,⁷ since the United States taxes its citizens and residents on their worldwide income.

US Real Estate

The United States taxes non-US persons on gains from US real estate, including any US real estate held (either directly or through a partnership or other passthrough entity for US tax purposes) at the time a treaty election is made. An individual who is planning to emigrate from Canada to the United States, and who owns US real estate, will therefore be subject to US tax on any gain in the real estate if the individual makes the treaty election.⁸ However, the US tax should generally be creditable against the individual's departure tax on the

real estate. To avoid a timing mismatch, the individual should not elect to defer the departure tax for Canadian tax purposes in respect of the US real estate.

Partnerships

Canada's departure tax generally applies to a partnership interest, including an interest in an entity classified as a partnership for US tax purposes, such as shares of a Canadian unlimited liability company (ULC) that has not elected to be classified as a corporation for US tax purposes (a "check-the-box" election) and has more than one owner. An individual's treaty election results in a stepped-up US tax basis in the partnership interest, and it may also be desirable to step up the "inside" US tax basis of the partnership in its assets. For example, if the partnership has depreciable or basis over time and to allocate US tax deductions to the individual. This inside basis step-up can be obtained through an election made by the partnership under section 754 of the Internal Revenue Code.⁹ This election, which operates when a partnership interest is transferred (including as a result of a treaty election), creates inside basis for the transferee in the assets of the partnership. If a section 754 election is not made, any difference between the individual's "outside" basis in the partnership interest and the partnership's inside basis in its assets at the time the partnership winds up will be eliminated, either through the transfer of the outside basis to assets that are distributed in kind or, if assets are sold, through an offsetting loss that the individual recognizes in the partnership interest. The US tax rules with respect to partnerships with inside/outside basis differences are complex and, depending on the facts, could have adverse results (including, possibly, recognition of ordinary income and a capital loss that might not be usable against the income). Accordingly, US tax advisers should be consulted when planning for emigration involves a partnership or an entity classified as a partnership for US tax purposes.

Estate Freeze Transactions

The goal of an estate freeze is to freeze the value of an asset or entity for one person and to allow any future growth to accrue for the benefit of other persons, typically family members. In an estate freeze, one family member ("the parent") acquires fixed-value preferred shares and another family member ("the child") acquires common shares in a Canadian corporation or ULC. The United States may treat an estate freeze as a gift from parent to child for US tax purposes.¹⁰ Because a donor who is a US domiciliary is generally liable for US gift tax (subject to an annual exclusion and lifetime credit), a Canadian who is planning to emigrate to the United States might consider executing a freeze before becoming a US domiciliary so that the transaction would not be subject to US gift tax (or erode the parent's lifetime gift tax credit).¹¹

Combining a pre-emigration freeze with a treaty election can produce advantageous tax results. A recipient of a gift of property generally takes the property with a basis equal to the donor's basis for US income tax purposes. In the case of a freeze transaction, where there is no actual transfer of property, the child's US tax basis in the common shares or interests will be equal to the amount that the child paid for them, which is typically a nominal amount. In addition, the parent, as a result of a treaty election, obtains a stepped-up US tax basis in the preferred shares.¹² The result would be optimal for both income and gift tax purposes because the parent does not make a taxable gift (or a gift that would erode the parent's lifetime gift tax credit). In addition, the parent would pay US tax only on preferred dividends received, but otherwise would have no income or gain on the frozen value, and the child would (appropriately) be taxed on all income and gain on the disposition of the child's interest. In the case of a freeze using a corporation (or other entity classified as a corporation for US tax purposes, including a ULC that makes a check-the-box election), the child's tax could potentially be deferred until liquidity is needed. In the case of a partnership (or other entity classified as a partnership for US tax purposes, including a ULC that does not make a check-the-box election), US family partnership rules typically require the income of the partnership to be allocated to the parent. This allocation is often a desirable result from a liquidity perspective,¹³ and also has the effect of deferring the child's tax.

Conclusion

Individuals who immigrate to the United States face a bevy of new US tax-reporting requirements (particularly with respect to assets held outside the United States) and are subject to US tax on their worldwide income. Canadian residents have a unique opportunity to make the treaty election as part of their tax planning, and they should engage US tax advisers early in the process to ease their future tax burden as US residents. Although the discussion above mentions certain planning with respect to US gift tax, immigrants should also consider

general planning for US gift and estate taxes before moving to the United States, and more careful consideration will be required when US-situs assets are involved.

¹Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the US-Canada treaty").

²The Internal Revenue Service (IRS) provides the procedure to make the treaty election for US tax purposes in Rev. proc. 2010-19 (www.irs.gov/pub/irs-drop/rp-10-19.pdf).

³Paragraph 128.1(4)(b) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). The exceptions include (i) real or immovable property situated in Canada, Canadian resource property, and timber resource property; (ii) capital property used in, and certain inventory of, a business carried on by the taxpayer through a permanent establishment in Canada; (iii) an "excluded right or interest," as set out in subsection 128.1(10) of the Act, which includes certain registered plans and trust interests; and (iv) certain gains of short-term residents. The province of Quebec imposes its own departure tax; that tax is beyond the scope of this article but should be taken into consideration by those planning to emigrate from Quebec. The United States also has adopted its own departure/expatriation tax, discussion of which is beyond the scope of this article.

⁴Subsections 220(4.5) to (4.54) of the Act. Note that, for Canadian tax purposes, an individual can elect to defer departure tax on a property-by-property basis.

⁵The treaty election is available even if the individual elects to defer the departure tax. While the treaty election is clearly available to a Canadian-resident individual emigrating to the United States (as outlined in Rev. proc. 2010-19, supra note 2), it may also be available to a Canadian individual emigrating elsewhere in the world. The election can provide a US tax basis step-up at the time of emigration and would be helpful if the individual moves to the United States at a later date. A word of caution: if the individual owns any US real property, the election will result in current US tax on the gain, and the individual will be required to file a US tax return, although, as discussed below, the US tax may be creditable against the departure tax.

⁶Article XIII(6) of the US-Canada treaty provides a step-up for US tax purposes in the cost of a departing Canadian resident's principal residence. A treaty election would not otherwise result in a step-up because Canada generally exempts from tax a gain from the disposition of a principal residence.

⁷Individuals immigrating to the United States from countries other than Canada must consider restructuring or other transactions in order to step up the US tax basis in their assets before immigrating.

⁸The IRS in Rev. proc. 2010-19 (supra note 2) takes the position that the treaty election must be made in respect of all the property of the departing individual, rather than on a property-by-property basis.

⁹Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

¹⁰Section 2701 of the Code.

¹¹Note that US gift tax applies to a gift of a US-situs asset, even if the gift is made by a nondomiciliary. US-situs assets include, among other things, US real estate, stock issued by a US corporation, and tangible assets within the United States. Also note that US income tax is imposed on US citizens and residents, while US gift (and estate) tax is imposed only on US domiciliaries, and the dates on which an individual becomes a resident and a domiciliary may not always coincide.

¹²Although section 2701 of the Code may treat the parent as transferring to the child all or most of the value of the company or partnership for gift tax purposes, from a US income tax perspective the parent continues to own the preferred shares, and therefore the tax basis can be stepped up through a treaty election.

¹³The family partnership allocation rules are intended to prevent abusive shifting of income from high-tax-bracket family members to low-tax-bracket members, but in the case of a freeze, the rules can work to the taxpayer's benefit.

This information and comments herein are for the general information of the reader and are not intended as advice or opinions to be relied upon in relation to any particular circumstances. For particular applications of the law to specific situations the reader should seek professional advice.