

US Tax ALERT

November 2004 – Issue 3-04

Tax ALERT is a synopsis commentary provided by Personal Wealth Strategies on topics of special interest – often topics relating to recent changes in the law, administrative practices or interpretations by taxation authorities. If you need more copies please call. Professional advice should be obtained before acting on any of this information. Ed Arbuckle FCA, CFP, TEP

CANADA / UNITED STATES CROSS BORDER TAX ISSUES

Whether you are an American citizen living in Canada or a Canadian owning a vacation property in the United States, there are and will continue to be many cross border tax issues. This **Tax ALERT** will outline some of the important considerations and reporting requirements. Future **Tax ALERT**'s will deal with specific areas in more detail.

From the Canadian side, the most significant issue seems to be Canadians owning US vacation property or spending significant amounts of time in the United States. From the US side, the most significant issue is usually about US citizens who have taken jobs in Canada – many in the technology sector. Such individuals are often in Canada from two to five years but some stay longer. Major tax issues can arise in sorting out the rules when they move to Canada or back to the US. While living in Canada, Americans will have to file both Canadian and US returns.

The major Canada / US tax issues can be broken down into four areas:

- ◆ Understanding Canadian and US tax laws and how their differences apply when reporting in either country
- ◆ Cross border tax rules (found primarily in the Canada – US Tax Treaty) meant to mitigate double taxation
- ◆ Issues with respect to Canadians receiving income from, owning assets in or living in the United States
- ◆ Issues with respect to Americans deriving income from, owning assets in or living in Canada

Canada / US Liability for Income Tax

Canada taxes individuals who live here (residents of Canada) on their worldwide income. Except in limited situations, a **resident** of Canada is not defined in Canadian tax law. When taxes are paid on income from sources outside Canada, subject to some limitations, Canada will allow a tax credit for foreign taxes paid in order to reduce or eliminate double taxation. Because Canada only taxes its residents, anyone leaving Canada to become a resident of another country must pay Canadian tax (departure tax) on unrealized gains. The departure tax does not apply to such income as pensions or RRSP's but Canada will get its tax bite through withholding taxes when such plans pay income to persons after they have moved from Canada.

The United States taxes **both** citizens and residents, so no matter where US citizens live, they will pay US income taxes and of course must file US tax returns each year. They will also continue to be liable for US estate and gift taxes (Canada no longer has estate or gift taxes).

Our Tax Rules are Simply Different

Wherever Canadians become entangled in US tax law or Americans become entangled in Canadian tax laws, the fun begins. Our laws are just different in many respects and taxpayers are often surprised (on both sides) how difficult it is to sort things out. Some examples:

- ◆ When you leave Canada you are deemed to have sold most of your property and will automatically establish a new cost base for Canadian tax purposes. But for US tax purposes the historical cost will still be recognized (usually to your detriment) unless it can be updated by some transaction.
- ◆ United States does not recognize RRSP's as a special tax entity.
- ◆ Canada Taxes only part of capital gains (50%) but the US has a separate rate of tax on capital gains. The US rate is almost always lower than the Canadian rate.
- ◆ The US does not have a \$500,000 capital gains exemption for the sale of shares of small business corporations so the exemption may be lost to US citizens living here.

The difference between each country's tax laws makes cross border tax planning important in order to minimize total taxes. Fore warned is fore armed. Essentially what taxpayers should be trying to do is to organize their affairs so that it is clear as possible how transactions are treated in both jurisdictions – no surprises!

Canadians Deriving Income From, Owning Assets In or Living in the United States

Canadians become entangled in US tax reporting as Snowbirds vacationing in the United States. The United States has codified their tax laws on the definition of a US resident so if Canadians are physically present in the United States for more than 183 days when adding the days in the current year to 1/3 of the days from the preceding year and 1/6 of the days in the second preceding year, they are deemed to be a resident of the United States. But if they can show they have a "closer" connection to Canada, the United States will not consider them to be a resident. To do this they must file Form 8840 with the US Internal Revenue Service every year.

There are other important areas that visitors to the United States must plan for in order to stay out of the US tax net. Among these is the liability for US estate tax on US vacation properties and the requirement to pay US income tax on rental income derived say from a Florida condo. Future issues of **Tax ALERT** will deal with more of these areas but suffice it to say Canadians who are physically present in the United States every year or have US property should have their US tax status reviewed by a professional advisor.

Americans Deriving Income From, Owning Assets In or Living in Canada

The plight of a US citizen deriving income from Canadian sources whether investment income, employment income or capital gains can also be complex. As indicated earlier, US citizens are subject to US income tax whether or not they live in the United States and so they end up filing both Canadian and US tax returns when living in Canada.

US citizens owning vacation homes in Canada but not living here are not subject to the same complex rules that apply to Canadians owning vacation homes in the United States. On the other hand, there are many Americans who have moved to Canada to become employees of Canadian corporations either for a few years or in some cases a lifetime. They are subject to Canadian taxes, as would any other resident of Canada. The more difficult problem comes from the requirement to continue to file US personal income tax returns. Since they are now living in Canada, the liability for US income taxes will be a foreign tax here and creditable against Canadian taxes. The Canadian tax return just got a little more difficult. Since Canadian taxes are generally higher than the US taxes, Americans will effectively only pay the Canadian government taxes on the difference between the higher Canadian taxes and the lower US taxes. In other words, American citizens living in Canada pay tax at the higher of the two rates.

Many Americans living in Canada have not filed US returns for years. The US Internal Revenue Service is quite generous for those who chose to start reporting in order to get on side with US requirements. If they apply for a US passport, the IRS will certainly catch up to them.

Forms for Filing With Canada and US Tax Authorities

There are many forms that should be filed both by Americans and Canadians when one becomes involved in the tax system of the other country. Following is a short list of the more important forms. Even if one does not have income from a particular country, it is often important to file a particular form in that country to protect yourself from possible adverse tax consequences – now or in the future.

US Forms – Forms for Canadian and Americans

<i>1040NR</i>	<i>Non Resident Alien Income Tax Return</i>
<i>3903</i>	<i>Moving Expenses</i>
<i>3520</i>	<i>Transactions with Foreign Trusts and Receipt of Foreign Gifts</i>
<i>2350</i>	<i>Application for Extension of Time to File US Return</i>
<i>2555</i>	<i>Foreign Income Exclusion</i>
<i>TDF-90.22.1</i>	<i>Report of Foreign Bank and Financial Accounts</i>
<i>8833</i>	<i>Treaty - Based Return Position Disclosure</i>
<i>8840</i>	<i>Closer Connection Statement</i>
<i>W8 – ECI</i>	<i>Exemption from Withholding of Tax (US Rental Income)</i>
<i>W7</i>	<i>Application for IRS Individual Taxpayer Identification Number</i>

Canadian Forms – For American and Canadians

<i>T2062</i>	<i>Request by Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property</i>
<i>T1135</i>	<i>Foreign Income Verification</i>
<i>T1248</i>	<i>Information About your Residency Status</i>
<i>T1141</i>	<i>Transfers or Loans to Non-Resident Trusts</i>
<i>T776</i>	<i>Rental Income</i>
<i>T1161</i>	<i>List of Properties by an Emigrant of Canada</i>
<i>NR73</i>	<i>Determination of Residency Status</i>

Some of the forms listed above are simply for tax compliance to allow Canada and US tax authorities to know what is going on. The problem is that failure to file some of these forms (even though no immediate tax is payable) involves hefty penalties for non-compliance.

Americans Owning Canadian Real Estate

Canada imposes a 25% tax on the sale price of Canadian real estate owned by non-residents at the time of the sale. The purchaser is liable to withhold the tax and must remit it to CRA. However, a non-resident owner can reduce the tax by filing form T2062 with CRA prior to the sale which will then take into consideration the cost of the property for Canadian tax purposes. A declaration by the vendor about his or her country of residence is on every real estate agreement to protect the purchaser who is liable for the tax if it applies and the inquiry is not made.

US Vacation Property

Protecting US vacation property from US estate tax has been a continuous challenge. One of the techniques sanctioned by CRA was to use a single purpose Canadian corporation so disposition did not occur on the death of the Canadian shareholder whose corporation owned the US property. CRA agreed they would not attempt to

tax owners on any personal benefit. CRA recently changed its mind on this and starting in 2005 no longer will sanction owning a vacation property in such circumstances without a personal tax benefit.

Summing Up

The cross border tax issues are many and can arise in cases where they are not even expected. If you have any substantial transactions across the border – watch out and get some professional advice.

Other Thoughts to Consider

In dealing with US tax laws our sense of logic as Canadians can get in the way. Here are a few things you should know if you are a US citizen living in Canada or a Canadian resident with US assets or family members:

- ◆ The IRS is suspicious of US citizens with any interests in non US trusts or corporations and will often look to tax them if possible
- ◆ If you have family members living in the United States be careful what you do in your Canadian estate planning – it may put them into an adverse US tax position now or in the future.
- ◆ If the beneficiary of a trust has full rights to encroach on capital, the IRS will effectively treat the trust assets as belonging to the beneficiary for US tax purposes.
- ◆ If you were born in the United States, have a US parent or were born outside the United States to US citizen parents, you are a US citizen and subject to US tax law.
- ◆ Citizens of the United States who give up their US citizenship are still considered US citizens for tax purposes unless they tell the IRS
- ◆ US gift taxes apply to US real property
- ◆ The IRS will try to get US situs property into the US tax net
- ◆ RRSP's have no special status in US tax law and are effectively treated as trusts. The IRS will look through to the assets of the RRSP to determine US tax treatment
- ◆ The IRS is expected to issue a prescribed form for disclosing RRSP contributions and investments in the coming years
- ◆ The Canadian departure tax does not apply to discretionary family trusts
- ◆ The Canada US tax treaty is going to be amended to increase the US cost base of assets deemed to be sold under Canadian departure tax rules when Canadians move to the United States
- ◆ When moving to the United States taxpayers should move as many assets as possible out of their estates by setting up a trust for a spouse for her health, education, maintenance and support
- ◆ When moving to the United States it may be possible to arrange your affairs to maintain your Canadian domicile to reduce the liability for US estate tax.
- ◆ Put life insurance into a life insurance trust before moving to the United States - especially if there is cash value
- ◆ The IRS will treat green card holders as residents and domiciled in the United States
- ◆ There is a rule in The Canada US tax treaty that will make you a resident of the United States if you are in the United States for a 31-day period assuming certain other conditions apply as well. So when departing the US try to do it in early January to avoid the residence designation in that year
- ◆ A typical Canadian estate freeze using a holding company has adverse tax consequences for anyone moving to the United States even though the foreign personal holding company rules have been cancelled
- ◆ If you are using trusts in your estate planning and there are US beneficiaries try to structure the trust to be resident in the USA as opposed to Canada
- ◆ Your US tax planning will become complicated if you have set up trusts for children and then they move to the United States

- ◆ The Unified Estate Tax Credit (currently 1.5 million dollars) is prorated for Canadians owning US property on the basis of US property to total property (as defined by US rules which for example would include life insurance)
- ◆ Do not buy US vacation properties in joint ownership with a right of survivorship. Use tenants in common ownership
- ◆ One of the best methods to reduce US estate tax is to register a non-recourse mortgage against the US property
- ◆ For US valuation purposes, minority interests will be discounted.
- ◆ US citizens can lower the value of their estates by making annual gifts of up to \$11,000 to anyone and \$114,000 to a spouse who is not a US citizen
- ◆ The use of Retirement Compensation Arrangements (RCA) can be beneficial to US citizens living and working in Canada for short periods of time to equalize the Canadian tax rate to the US tax rate say over a five year period

The above guidelines may only be good the day they are written so get professional advice. Both Canadian and US tax laws and especially cross border issues are constantly changing. Taxpayers with significant US assets should have US tax advisors - otherwise the consequences can be devastating. In many cases, US tax advisors need only be brought in when structures are set up and then consulted periodically thereafter.

*Personal Wealth Strategies provides **Tax ALERT** for clients and business associates on topics of current interest. We do not expect that all topics covered in **Tax ALERT** will be important to everyone but hopefully most readers will take away something helpful from time to time.*

*J. E. Arbuckle Financial Services Inc.
205 - 30 Dupont St. E., Waterloo, Ontario N2J 2G9
Phone: 519-884-7087 Toll Free: 1-877-883-3970 Fax: 519-884-7089
Email: info@finplans.net*