

TAXTALK

U.S. TAX UPDATE - 2006

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INTRODUCTION

Many Canadian resident taxpayers may be required to comply with U.S. taxation laws, either because they are (i) U.S. citizens living in Canada or (ii) Canadian citizens who are permanent residents of Canada with U.S. connections. Compared to our own taxation system in Canada, the U.S. tax system is quite different in many respects. Some of the more pertinent U.S. tax issues affecting Canadian residents are outlined below.

U.S. COMPLIANCE ISSUES FOR CANADIAN RESIDENTS

RENTAL AND SALE OF U.S. REAL PROPERTY

Canadian resident taxpayers¹ (generally considered to be U.S. non-resident aliens) who own and rent property located in the U.S. are generally subject to U.S. federal withholding tax of 30% of the gross rents. The withholding tax on gross rent may be avoided by reporting the gross rent and related rental expenses on a U.S. income tax return. In this way, the Canadian resident will only be subject to income tax on the **net** rental income. A non-resident alien income tax return (Form 1040NR) is generally due on June 15th of the following year.

¹ Who are not U.S. citizens.

Under the U.S. Foreign Investment in Real Property Tax Act (FIRPTA), when a non-resident alien disposes of a real estate property located in the U.S. a 10% withholding tax applies to the gross sale price. However, under certain circumstances, the 10% withholding tax may not apply or the withholding tax may be reduced by obtaining a withholding certificate from the IRS. The 10% withholding would not apply where the purchase price for the property is under US \$300,000 *and* the property is acquired by the purchaser as a home (with definite plans to reside in it for at least 50% of the time that the house is occupied in the first twenty-four-months after the purchase). Generally the seller obtains an affidavit from the purchaser confirming the use of the property to ensure that the conditions have been met for the withholding not to apply.

Form 1040NR is generally filed to report the resulting capital gain or loss. On filing of a U.S. tax return, any tax withheld on the sale may be applied against the actual income tax resulting from the capital gain. All or part of this withholding tax may be refunded if the withholding tax exceeds the actual tax payable, if any, in respect of the sale.

The U.S. income tax rates that apply to net capital gains are generally lower than those that apply to other income. The current capital gains tax rates are 5%, 15% or 25%.²

In order to file Form 1040NR, the Canadian resident needs an Individual Taxpayer Identification Number.

U.S. INDIVIDUAL TAXPAYER IDENTIFICATION NUMBER (ITIN)

All individuals who are required to file U.S. income tax returns must have either a U.S. Social Security Number (SSN) or an ITIN.

U.S. citizens, Green Card holders and individuals working in the U.S. under work visas or permits are issued SSNs. All other individuals, including non-residents, as well as spouses and dependants of U.S. residents who are not eligible to obtain a SSN, may obtain an ITIN. An ITIN is an identification number used for tax purposes only. Without an ITIN, dependent personal deductions can not be claimed on the U.S. return. Also, without an ITIN, a non-resident cannot apply for a U.S. withholding tax exemption on the sale of U.S. real property.

Individuals requiring an ITIN must file Form W-7 (Application for IRS Individual Taxpayer Identification Number) and provide original documentation³ to substantiate their foreign status and true identity to the Internal Revenue Service (IRS). The IRS authorizes "Acceptance Agents" who may certify the documentation and send the application to the IRS to obtain the ITIN for the taxpayer. **McCarney Greenwood LLP** is an authorized Acceptance Agent and can assist individuals in obtaining ITINs.

² *The tax rates that apply to capital gains depend on various factors such as the length of time the property was owned, the taxpayer's income level, the filing status of the taxpayer and the type of capital gain, etc.*

³ *Original documentation includes a birth certificate and photo identification, i.e., passport, driver's licence, etc.*

U.S. TAX RESIDENCY FOR CANADIAN SNOWBIRDS

Have you realized that lifelong dream and now spend winters in Florida, New Mexico, Arizona or another warm weather state? Did you know, even if you do not earn a penny from the U.S., under U.S. tax law you may be considered resident in the U.S.? In the U.S. there is a substantial presence test that is a 3-year test. Specifically, if in the current year you are in the U.S. for more than 31 days, and the aggregate of:

- all of the current years' days, plus
- 1/3rd of the days from the preceding year, plus
- 1/6th of the days from the 2nd preceding year

is greater than 182 days, then you are considered a resident in the U.S. for U.S. tax purposes. A day even includes a shopping trip to Buffalo, or a night looking at Niagara Falls from the U.S. side. If you meet the substantial presence test, then you are required to file a U.S. Form 1040 federal income tax return and report and pay tax on your **worldwide** income, **unless** you use the provisions under the Canada-U.S. Tax Convention (Treaty) to make a closer connection election, as discussed further below.

In order to obtain relief from U.S. taxation where an individual is considered to be a resident of both Canada and the U.S., there are "tie breaker" rules under the Treaty. These rules determine in which country the individual will be considered to be resident for tax purposes. In general, the tie-breaker rules consider the person's permanent home and/or the country with which his or her personal and economic relations are closer (centre of vital interests).

Form 8840 (Closer Connection Exception Statement) must be filed with the IRS to support that the individual is a non-resident of the U.S., i.e., the individual's tax home is in Canada and that the individual has more significant contacts or ties with Canada during the year than with the U.S. A separate Form 8840 must be filed for each individual claiming the closer connection

exception, i.e., spouses and children must each file a Form 8840. The form must be filed with the IRS by June 15th of the following year. If the individual is required to file Form 1040NR for the year, Form 8840 should be attached to the return. Individuals who do *not file* Form 8840 to claim a closer connection to Canada will be considered a resident alien for U.S. tax purposes and thus taxable in the U.S. on their worldwide income.

CANADIANS WORKING IN THE U.S.

Canadians who work or provide services **in the U.S.** may be subject to U.S. tax on the portion of their salaries and business incomes that are attributable to those services provided in the U.S. As such, they are required to file a U.S. tax return.

Individuals who spend **more than 183 days** in the U.S. in any particular year while working for a **Canadian employer** which does **not** have a place of business in the U.S., will be subject to U.S. tax on the portion of their salary earned while they are physically present in the U.S.

Canadians working in the U.S. for **U.S. employers** are liable to file a U.S. tax return and pay U.S. tax on the salaries related to the U.S. work, regardless of the time that they actually spend in the U.S.⁴

Although any U.S. tax paid can be claimed to reduce/eliminate Canadian tax due on this income, a U.S. tax return will still need to be filed and the U.S. taxes owing will need to be paid in respect of this income. The returns are required to be filed by April 15th of the following year.

⁴ Under the Canada-U.S. Tax Convention (Treaty), Canadians, who earned compensation not exceeding US \$10,000, were not present in the U.S. more than 183 days in the calendar year and worked for a Canadian company that did not have a fixed place of business in the U.S., are **not** subject to U.S. taxation on these earnings. There is no requirement to file a U.S. tax return in respect of this income.

U.S. ESTATE AND GIFT TAX: TRAPS TO AVOID

(i) General Comments

Canadians have not had to deal with an estate tax for a very long time. In Canada, there is the deemed disposition rule on death, which causes accrued capital gains to be deemed to be realized for income tax purposes. However, there are automatic rollover provisions that apply when assets are transferred on death to a spouse or a spousal trust. Meanwhile, the U.S. still has estate tax as well as gift tax and generation skipping transfer tax (GSTT) that are commonly referred to as "transfer taxes".

There have been many publicized reports about the potential repeal of the U.S. estate tax, including the increased exemption amounts and reduced tax rates. However, this information can be misleading. For a person who is not a U.S. citizen, lawful resident (Green Card holder) or U.S. resident alien, the exemption amount from U.S. estate tax has not changed and remains at US \$60,000.⁵

What does this mean and how is it applied? The first step is to identify the property that is subject to U.S. transfer taxes. Property subject to estate tax, gift tax and GSTT may not be the same as property subject to Canadian income tax.⁶ Secondly, the amount subject to tax is the **fair market value** of the asset on the date of death or the date when a gift is made. Contrast this to Canada, where it is the **gain** on the asset that attracts Canadian tax.

⁵ The basic estate tax credit of US \$13,000 (equivalent to estate tax on the first US \$60,000 of U.S. property) is potentially increased for Canadians under the Treaty. For 2006, the tax credit is US \$780,800 (equivalent to the estate tax on the first \$2,000,000 of U.S. property).

⁶ U.S. property subject to U.S. estate tax includes taxable personal property and real estate located in the U.S., stocks of U.S. corporations (even if held in a Canadian brokerage or RRSP account), U.S. pensions, annuities, debt obligations and life insurance plans.

(ii) Example

What can all this mean? Assume for a moment that the U.S. and Canadian dollars are trading at par:

- (1) A *Canadian resident* who is not a U.S. citizen has shares of a U.S. company with a basis of US \$100,000 and sells them for US \$200,000. Under the Treaty the gain on the sale of the shares are only taxed in Canada and are considered Canadian situs property.
- (2) What happens if the person gives the shares to (say) his child who recently graduated from law school? For U.S. gift tax purposes, the shares are considered Canadian situs property and thus not subject to U.S. gift tax.
- (3) What if the person dies while owning the shares rather than selling them before death? If the shares are being transferred to the surviving spouse who is living in Canada and is not a U.S. citizen, then there is no Canadian income tax due to the spousal rollover rules, but what about the U.S.? The U.S. considers the shares to be U.S. situs property and the shares are part of the U.S. gross estate subject to U.S. estate tax on the fair market value of US \$200,000. In the U.S., there is an unlimited marital rollover provision for estate tax, but only if the surviving spouse is a U.S. citizen.⁷
- (4) Continuing with our example, although the exemption amount for a non-resident alien is US \$60,000, under the Treaty a higher exemption is available to a Canadian resident.⁵ The treaty exemption is a ratio of the U.S. gross estate divided by the worldwide gross estate, times the higher exemption amount for 2006 of US \$2 million allowed to U.S. citizens. A

⁷ If the surviving spouse is a Green Card holder or a U.S. resident alien, there is no rollover and thus, these will be exposed to U.S. estate tax.

person can elect this alternative exemption if it is higher.

- (5) As mentioned above, if the beneficiary of the property is the surviving spouse (who is a U.S. citizen) and the property would be eligible for the spousal rollover available for U.S. tax purposes, then the Treaty has another exemption available for assets transferred to the spouse.

The Treaty also provides that the U.S. estate tax will be available to offset the Canadian income tax associated with any gain on the deemed disposition of the property, to the extent that there is Canadian tax assessed on the gain.

(iii) Buying a U.S. Vacation Home

A common U.S. transfer tax issue arises where a person is buying a vacation home in the U.S. Buying the home could inadvertently subject you to the U.S. gift tax. When purchasing a home, it is not uncommon for one spouse to make the offer and write the deposit cheque and then at closing have the house put into joint names. Placing the property in joint names can inadvertently subject the purchase to U.S. gift tax. The gift tax issues start when the offer to purchase is in the name of only one party and it is accepted by the vendor. When the title goes into both names, for U.S. tax purposes, there is a transfer of an interest in U.S. real property by way of a gift. The gift relates to the contract right in the property held by one spouse that is transferred to the other spouse giving that other spouse the right to receive the interest in the property by way of the title. In this case, there may also be an issue regarding FIRPTA but that is beyond the scope of this TaxTalk. The best approach for buying a U.S. vacation home is to ensure that the offer includes all of the names of those persons who will be on legal title to the property.

There is another innocent mistake that can create a U.S. gift tax issue. If the deposit or closing funds go to the U.S. escrow holder from the account of only one of the buyers, then there is a gift at the time of the closing from that "buyer" to the other "buyers". The funds are considered

U.S. situs property for gift tax and the acquisition of the interest in the property by the person not providing the initial funds is a gift to that person of a proportionate share of the money equal to the proportionate share of interest acquired in the property. In this case, it is best to have separate cheques come from segregated accounts in case the IRS traces the source of the funds back to the buyers.

The purchase of a vacation property also provides a planning challenge for U.S. estate tax. In the past, to escape U.S. estate tax, common planning was to hold the U.S. vacation property in a Canadian Sole Purpose Corporation. As a result of a recent change in administrative policy, the Canada Revenue Agency has stopped allowing this type of alternative ownership structure. Consequently, structuring the ownership of U.S. property is more of a challenge for U.S. estate tax purposes. Factors to be considered include the purpose of owning, length of ownership, estate assets and other factors. It is beyond the scope of this TaxTalk to go into this detailed planning in this respect. It is advisable to consult with your tax advisor before considering a purchase of a U.S. vacation property.

U.S. COMPLIANCE ISSUES FOR U.S. CITIZENS/RESIDENTS

U.S. TAX RULES FOR REPORTING AND DEALING WITH CANADIAN RRSPs AND RRIFs⁸

Are you a U.S. citizen residing in Canada, or a Canadian who is residing in the U.S.? If so, then you need to be aware that Canadian and U.S. tax rules differ in respect of contributions, accumulating income and distributions. In Canada, RRSPs and RRIFs are not subject to tax as income accumulates and contributions reduce taxable income. However, for U.S. taxation this is not the case. Tax savings are not realized in the U.S. for RRSP contributions, that is, the contribution into the plans does *not* reduce U.S. gross income. Also, any accumulation of

income, capital gains, etc. in the plans are generally subject to U.S. federal income tax and possibly state income tax in the year earned or realized within the plan (if resident in the U.S.). State tax laws determine whether any accumulation is, or is not, subject to state income tax since the individual U.S. states are not signatories to the Treaty.

There is relief available from the U.S. federal tax that would otherwise be due on RRSP/RRIF earnings. The Treaty permits a person to make an election to *defer the U.S. federal income tax* on the accumulation until it is withdrawn from the plan. The election is a one time election for each RRSP/RRIF. It is irrevocable. The election is included as part of Form 8891 (U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans). A separate Form 8891 must be filed each year, in a timely manner, with the individual's U.S. tax return. Information required to be reported on Form 8891 includes the name and address of the plan administrator, the plan number and the balance within the plan on December 31 of a particular taxation year.

The election defers U.S. federal tax on the accumulations within the plan until there is a distribution from the plan. As such, the timing of Canadian and U.S. tax on any distribution will occur in the same year, thus providing for the ability to offset U.S. income tax with a "foreign tax credit" relating to the Canadian income tax paid in the year of withdrawal.

Please note that a distribution from the plan is defined by U.S. tax law, and not Canadian tax law. For example, a withdrawal under the Home Buyers' Plan from an RRSP is not taxed in Canada, but it is a taxable distribution for U.S. tax purposes. Although U.S. income tax is payable on the distribution, there is no U.S. penalty applicable for early distributions, as can apply on U.S. retirement plans.

⁸ These U.S. rules can also apply to Canadian RPPs, DPSPs, and RESPs.

On distribution from the plan, all of the income and capital is taxed in Canada at ordinary tax rates. Meanwhile, the U.S. taxes the accumulation of income only. Thus, it is important that there is adequate tracking of contributions, capital trades, dividends and other income credited to the plan for annual currency translations. If these items are not tracked by year and historical exchange rates, the tax cost basis of the plan may be incorrect.

It is common for many people to include the total distribution (i.e., income and capital) as "income" on their U.S. return and then offset the U.S. tax with the Canadian tax. This approach, however, can cause state tax to be incurred unnecessarily, since most states do *not* allow a foreign tax credit related to Canadian income tax. In this case, the best approach is to report only the accumulation of income for U.S. income tax purposes, to ensure only the required U.S. federal and state tax is applied, thereby avoiding excess U.S. taxes which may not be eligible for a foreign tax credit relating to Canadian income tax paid.

U.S. tax law considers Canadian tax deferral plans to be grantor trusts. This allows the income to maintain its character. As such, capital gains and qualified dividends earned within the plan will be taxed at the more favourable rates in the U.S., which, depending on the effective tax rates and whether the taxpayer is resident in Canada or the U.S., can lead to significant tax savings. If the taxpayer is resident in the U.S. they may benefit further depending on which state they reside in, since some states have more favourable tax rates on passive income. Unlike the U.S., if the taxpayer is resident in Canada, all income distributed out of an RRSP or RRIF is treated as pension income.

For U.S. citizens and residents, the disadvantage of *not making the election* on Form 8891 with respect to the RRSPs and RRIFs is that they are required to include the income earned or realized annually within the plan in their U.S. tax return, and pay U.S. income tax thereon. The income does retain its character for U.S. tax purposes, so

dividends, capital gains and losses are reported separately.

If you do not file Form 8891, then there are other reporting requirements in the U.S., **both by you and the plan administrator**. Failure to file a report in a timely filed return (including extensions) carries a penalty, separate from the penalty assessable for a late filed return. The penalties for failing to file these reports as required can be significant - they can equal more than 50% of the *value* of the plan for each year of a filing deficiency.

All in all, it is prudent to file Form 8891 and elect to defer U.S. taxation on income earned in the Canadian deferred plan until distributions are made.

When a person is preparing to terminate their residency in Canada to move to the U.S., there are a couple of things to consider with respect to their Canadian tax deferral plans. First, investments with accrued gains should be sold and repurchased within the plan, thereby crystallizing the gains and increasing the cost or capital basis of the plan for U.S. taxation. Secondly, the taxpayer should discuss their move with the plan administrator prior to the move to confirm that the Canadian administrator can continue to administer the plan and deal with the taxpayer when they move to the U.S. At issue is whether the Canadian administrator can deal with U.S. residents.

FOREIGN ACCOUNTS REPORTING TO THE U.S. DEPARTMENT OF TREASURY

U.S. citizens and U.S. residents are required to file a report annually with the U.S. Treasury Department disclosing foreign (in relation to the U.S.) financial accounts held during the year if, on an average at any time during the calendar year, the value in the accounts is more than US \$10,000 **in the aggregate**. The report is not part of the federal income tax return and is required to be filed annually, on or before June 30th of the following year.

The instructions to the report do not define ‘an account.’ However, an account does include bank accounts, securities accounts, RRSPs, RRIFs, EPSPs, DPSPs and RPPs. There are other accounts that are frequently not thought about that are required to be reported. These include corporate accounts that you have signing authority on, a child’s “in-trust” account where you are on the account as the guardian or trustee, and other accounts that you have signing or control authority over, even though you are not the owner of the assets in the account. An account also includes life insurance that has an investment component (a Universal Life Policy), GICs, private loans, and other instruments. The stated purpose for the requirement to file the report is to track money laundering activities. More recently, the IRS has taken control for the filing of these reports and now has another tool to combat tax evasion/avoidance, and to determine if all income is being reported and if assets are owned offshore. The wilful failure to disclose these accounts is a felony and carries significant penalties; even the inadvertent omission of an account carries a significant penalty.

U.S. CITIZENS AND GREEN CARD HOLDERS – THE NEW EXPATRIATION RULES

Unlike Canada, which levies taxes on world-wide income of Canadian **residents**, the U.S. taxes the world-wide income of its citizens and former long-term residents (‘Green Card holders’), no matter where they reside. U.S. transfer taxes (estate, gift and generation-skipping) also apply to the world-wide estates of U.S. citizens and Green Card holders residing outside the U.S.

In 2004, the U.S. Congress introduced new rules with respect to (i) U.S. citizens who wish to renounce their U.S. citizenship and (ii) U.S. Green Card holders who want to, or are required to, surrender their card. Under these new rules, these individuals may have U.S. tax reporting obligations for **up to ten years** following expatriation from the U.S.

The new rules strengthen the U.S. government’s ability to tax its citizens after they leave the U.S., and apply to expatriations occurring after June 3, 2004. New objective tests determine if an expatriate will automatically be subject to a special **alternative tax regime**.⁹ The new rules apply, if any of the following four tests are met, specifically, where an individual:

- (i) has a net worth of US \$2,000,000 on the date of expatriation,
- (ii) has an average annual net income tax for the five years prior to expatriation exceeding US \$124,000 (indexed),
- (iii) fails to certify that they have satisfied all of the requirements in the Internal Revenue Code for the five years preceding the date of expatriation, **or**
- (iv) fails to give notice of expatriation.

Expatriates subject to this alternative tax regime are also required to file an annual information return¹⁰, for each of the ten years after expatriation. A special rule has been added to determine when an individual expatriates for U.S. tax purposes. Dual citizens and minor children are exempt from the new rules.

In addition, expatriates who are physically present in the U.S. for more than 30 days, during any year, in the ten-year period following expatriation, are taxed as residents of the U.S. for that particular taxation year. The rules also require these expatriates to file the annual information return for each of the ten years after expatriation, in which they are taxed as a U.S. resident due to their physical presence exceeding 30 days.

Although Treaty relief may eliminate double taxation, U.S. citizens and Green Card holders are burdened by onerous reporting requirements, under threat that those who are non-compliant will be refused entry into the U.S.

⁹ Under the alternative tax regime, the expatriate is subject to expanded U.S. income, estate and gift tax on certain foreign sourced income in addition to income for which U.S. non-residents are generally liable.

¹⁰ The penalty for not filing the annual return is US \$10,000.

The U.S. and Canada have a system to exchange information and with the increased government data collection activity since 2001, the U.S. now has the tools to discover Canadian residents holding these Green Cards and enforce their tax laws. For many Canadians holding Green Cards, the new rules¹¹ relating to the process of surrendering the card may be the most problematic due to the complexity and far reaching implications of these rules. Green Card holders need to plan what to do with their Green Cards and going forward will need to consider their U.S. tax reporting for past and future years should they want to take a position that their Green Cards are still valid.¹²

CONCLUSION

As we can see from the above discussions, U.S. tax rules are complex and can adversely affect Canadians who own real property in the U.S., own U.S. situs assets, spend time in the U.S., are a Green Card holder or have other U.S. connections. Accordingly, planning to deal with the U.S. rules is crucial so as to avoid or reduce U.S. income, estate and gift taxes and/or exposure to any non-compliance penalties that could be applied.

¹¹ The new rules put the onus on the Green Card holder to notify the U.S. of their intent to surrender their card.

¹² The issue as to whether the Green Card is still valid for U.S. immigration purposes is beyond the scope of this discussion and may have no relation to the U.S. income tax implications of having a Green Card.

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Abbreviations used herein:

RRSP	Registered Retirement Savings Plans
RRIF	Registered Retirement Income Fund
RPP	Registered Pension Plan
DPSP	Deferred Profit Sharing Plan
RESP	Registered Education Savings Plan
EPSP	Employee Profit Sharing Plan

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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