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Tax Issues related to holding Canadian assets, Estate issues & other matters

**Carol-Ann Simon, Shareholder
Masataka Yamaguchi, International Tax Manager**

January 14, 2014

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Case Study: Client Assumptions & Goals



- › Brad & Barbara are in their 50's with 2 teenage daughters
- › They are Canadian citizens and residents and will soon move to Oregon for Brad's new job opportunity. They will stay at least 2 years.
- › Unsure if this move is permanent, they will rent their home in Canada.

Assumptions & Goals (cont.)



- › They will rent a home in the US until they make their decision on staying permanently.
- › They will leave their investments in Canada for now.

Assets & Liability



Assets		
RRSP's	Brad	\$500,000
	Barbara	\$200,000
Mutual Fund Trusts	Brad	\$300,000
	Barbara	\$150,000
RESP's (education savings plans)	Each Child	\$20,000
Stocks	Brad	\$400,000 (unrealized gain \$200,000)
Principal Residence		\$1,500,000 (unrealized gain \$700,000)
Unexercised Stock Options		\$10,000 share options
Liability		
Mortgage		\$500,000

Canadian Consequences



- › Demonstrate that you are leaving Canada for at least 2 years, and are acquiring residency in another country - Canadian tax residency will cease.
- › Deemed disposition of all capital assets* at market value – pay capital gain tax (aka “departure tax”)
- › Will no longer be taxed on worldwide sources of income, only Canadian sources.

*Except Canadian property such as real estate or shares in a Canadian controlled private corporation.

Deemed Disposition of Assets



- › Canada/US protocol to treaty (2007)
 - To prevent double tax, you can make an election in the US to deem the disposition and reacquisition of your assets at fair market value, so that the “taxing moment” is the same in Canada and the US. (i.e. they can claim a foreign tax credit)
- › Planning Point
 - Since the tax needs to be paid anyway, consider actually selling the assets subject to deemed position.

Rent of Canadian Home



- › Default rule: NRT of 25% to be withheld on gross rent
- › Election available: Voluntarily file a separate Canadian rental tax return for this income (called “Section 216 Return”), reporting all income and related expenses. Pay Canadian tax at graduated rates on net income.

Rent of Canadian Home (cont.)



- › To prevent 25% NRT throughout the year-

File NR6 before renting, and for each new tax year. Withholding is on projected net rent only, and commit to filing a “216” Canadian nonresident return.

Sale of Canadian Principal Residence After Move to US



- › Selling Canadian real estate as a nonresident is subject to 25% NRT withheld on the gross proceeds (much like the US FIRPTA regime for US nonresidents)
- › Apply for a “clearance certificate” with Canada Revenue Agency before sale, since gain on a sale of a principal residence is exempt. Reduces/prevents withholding. (Form T2062, or Form T2062A if rented out)
- › Do this application as soon as you have an offer, in order to get CRA response in time for closing.

Sale of Canadian Principal Residence After Move to US (cont.)



- › Canadian principal residence exemption is year by year – if hold property while also a non resident of Canada, or while use is changed to a rental, exemption is prorated and a portion of any gain is then exposed to Canadian tax.(Form T2091)
- › Once you apply for tax clearance certificate – you commit to filing Canadian nonresident return to prove your exemption or reduced tax.

Change in use of an Asset



- › Canada has “change in use” rules for assets – once you change a personal property to business property (i.e. rental) you trigger a deemed disposition. (Also true in reverse.)
- › You can elect not to have the change in use disposition if converting a property from or to a principal residence.
- › Cannot have ever claimed Canadian depreciation while renting in order to make these elections.

US Tax Consequences: Rental Income on Canadian Home



- › All income and expenses reported on resident US returns.
- › Depreciation claimed according to US rates and rules (must use 40 yr SL, not 27.5 MACRS)
- › Rental losses may be denied as a current deduction under the passive activity rules, if gross income over \$150K.
 - When selling a Canadian residence that was rented, any passive losses from that activity will be freed.
 - Upon sale, check if US “2 out of 5 years” rule applies to claim US principal resident exemption.

Exchange Effects



- › Watch out for potential gain on extinguishment of foreign debt such as a mortgage. If pay off a foreign debt with fewer US dollars than when the debt obtained, can be a foreign exchange gain that is taxable.

Note: gain cannot be offset by exchange loss on sale of home

Canada-US Tax Convention



- › Special feature: Article 13, Paragraph 6
 - If you have a home that was your principal residence at the time you left Canada and you sell it while residing in the US, the US basis shall equal fair market value at time of sale.
 - Avoids potential US tax on gain (i.e. if US rules don't allow for full exclusion of gain)
(i.e. US domestic law would only give \$500,000 exclusion for joint filers, \$250,000 gain for separate/single filers)

RRSP's/RRIF's



- › US domestic law would tax any earnings in these plans if not for an election to defer under the Canada-US tax treaty
- › Taxation of withdrawals:
 - US taxes the increase in value in the RRSP once you have left Canada
 - Value built up in the plan up to date of leaving Canada is treated as basis (much like US annuity rules in S.72), plus any income you choose to have taxed instead of deferring.

RRSP's/RRIF's (cont.)



- › Canada withholds 25% NRT on lump sum withdrawals, and 15% on periodic distributions from RRIF's or other annuities
- › Can claim foreign tax credit in the US, but not on the portion that the US considers non-taxable basis. (Oregon allows foreign tax credits up to \$3,000, but since it is part of the federal tax deduction not much relief).
- › Could also claim the foreign tax paid as an itemized deduction, but watch for AMT.

Special Reporting



- › TDF 90-22.1 Report of Foreign Bank Accounts (“FBAR”)
 - Bank accounts, Stock brokerage accounts, mutual funds
 - RRSP’s/RRIF’s, company pension plans
 - Whole life insurance
- › Due by June 30 – large penalties if don’t disclose
- › Huge emphasis area by the IRS

Offshore Voluntary Disclosure Program



- › All unreported income from offshore accounts must be reported on a US income tax return, and taxes paid – severe penalties still, but better than if the IRS catches you first.
- › If income unreported, obtain legal advice – program is run by IRS Criminal Investigation Division
- › If income has already been fully reported and just the Report of Foreign Bank accounts not done – they can be filed with a “reasonable cause” reason chosen. Must be electronically filed now.
- › Alternative is to just file amended returns “quietly”, but still get legal advice. The IRS’s position is that you cannot just amend.

Social Security Income



- › Brad & Barb are concerned that since Brad plans on working only another 9 years until retiring, those years will not generate a social security income in the US.
- › Refer to the Canada-US Totalization Agreement (and separate Quebec-US understanding)
- › Agreement works to maximize potential payout for a dual country career.
- › Benefits Programs Covered:
 - US – Social Security, disability and survivors insurance (not Medicare services or SSI)
 - Canada – Canada Pension Plan and Old Age Security (not GIS)

Social Security Income (cont.)



- › If you do not meet the minimum years of service in one country to qualify for a pension, you can use the years of service in the other country to qualify (i.e. “totalize” years of service).
- › **US minimum-**
 - Must work 10 years to get a social security pension
 - But, under Totalization - if you work at least 1 ½ years in the US, you qualify to add in your years of Canadian work to qualify for US pension.
 - Pension would be prorated.

Note: Canadian social pension income treated like US social security on the 1040, under the treaty

Estate Tax



- › Unlike the US, Canada does not have an estate tax.
- › Canada has deemed disposition rules of assets at death (much like the dispositions deemed when becoming nonresident), unless assets rolled over to the spouse.
- › Although technically this is an income tax, and the US estate tax is a “value tax”, the Canada-US treaty allows credit to eliminate double taxation.

Estate Tax – Non-US Decedent



- › Subject to estate tax only on US situs assets (vs. worldwide assets for US decedent).
- › Applicable exclusion amount is only \$60,000 (vs. \$5,340,000 for US citizen decedent) absent any treaty benefit.

Estate Tax – US Situs Assets



- › What is US situs asset?
 - Real property located in US
 - Tangible personal property located in US
 - Stock issued by US corporations
 - Debt owed by US person
 - Partnership interest (?)

Estate Tax – Exemption under Treaty



- › Exclusion under certain treaties linked with the one available to US citizen decedent. For example:
 - US condominium \$1,000,000
 - Canadian situs assets \$6,500,000
 - Pre-credit estate tax on \$1,000,000 = \$345,800
 - Prorated credit = $1,000,000 / 7,500,000 \times 2,081,800 = \$277,573$
 - Estate tax after credit = $345,800 - 277,573 = \$68,227$

Estate Tax – Reducing Exposure



- › Reduction in value of taxable estate
 - Non-recourse debt
 - Potential change in situs
 - Unlimited marital deduction in case of surviving US citizen spouse

Transfer Tax Implications with Non-US Citizen



- › Deceased spouse receives full amount of unified credit to shield his/her assets worth \$5,340,000 if resident in US.
- › Unlimited marital deduction **unavailable** to transfers to noncitizen spouse
 - Annual exclusion of \$145,000 (2014)
 - Qualified Domestic Trust
 - Become a US citizen!

Foreign Tax Credits under Canada-US Treaty



- › Canadian resident, non-US citizen
 - US estate tax only on US situs assets
 - Credit against final Canadian income tax
- › Canadian resident, US citizen
 - US estate tax on worldwide assets
 - Canadian income tax on deemed sale of worldwide assets
 - Credit against final Canadian income tax for US estate tax arising from US situs assets
 - Credit against US estate tax for final Canadian income tax arising from deemed sale of non-US situs assets

Questions?



Carol-Ann Simon

csimon@perkinsaccounting.com, 503-221-7580

Masa Yamaguchi

myamaguchi@perkinsaccounting.com, 503-221-7542

Perkins & Co perkinsaccounting.com

503-221-0336



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