The TaxLetter®

Vol. 32, No. 4 Your Guide to Tax-Saving Strategies April 2014

TAXMATTERS

Make your annual trek south for the winter more relaxed by avoiding…

Snowbird tax traps

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This year's cold and lengthy winter had me constantly daydreaming of beaches and warmer weather. I certainly envy those lucky ones who head south at the first sign of snow.

The only thing that makes me a little less envious is the knowledge that those Canadian snowbirds down in Florida, enjoying the sun and sand for months at a time, also have to deal with the potential tax traps that Uncle Sam has carefully laid out for them.

Living Abroad:

Although you may consider yourself a resident of Canada, and you've duly filed your Canadian tax each spring, be aware that if you spend a substantial portion of the year in another country, you may be found to be resident in that country for tax purposes.

This can, in turn, lead you to more tax headaches than you imagined. For example, if you are found to be resident in the U.S. for tax purposes, you will be taxed in the U.S. on your worldwide income in much the same manner as a U.S. citizen. That means you will be required to file a U.S. tax return and pay U.S. tax on your income from all sources.

Specially, you will be resident in the U.S. if you meet the lawful permanent resident (or green card) test, or the "substantial presence" test. Under the first test, if you have a green card, you will be treated as a U.S. resident, regardless of whether you are physically present in the U.S. The second test, however, requires a little more analysis.

"Substantial Presence"

Under the "substantial presence" test, you will be considered a U.S. resident if you spend a substantial portion of the year in the U.S. This test is calculated (generally) as follows:

- You have been in the U.S. for more than 30 days in the current year; and
- If the total number of days you spent in the U.S. during the current year, plus one-third of the days you spent there last year, plus one-sixth of the days you spent in the year before that, equals or exceeds 183 days.

You can, therefore, spend up to 120 days each year in the U.S. without crossing this threshold test. When calculating the number of days, you should know that a partial day in the U.S. counts as a full day, although you can exclude days that you were in transit in the U.S. (for less than 24 hours) on your way to another foreign country.

As well, you may be able to exclude days spent as a teacher, trainee, student, or professional athlete competing in certain charitable sporting events.

If you meet the above "substantial presence" test, you will be subject to U.S. tax and filing requirements, even though you may also be a Canadian resident

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and pay Canadian taxes.

In case you are considered a U.S. resident, you can try to extricate yourself from the U.S. by either claiming the "closer connection exception" allowed under the U.S. Internal Revenue Code, or claiming a treaty exemption under the Canada-U.S. Tax Treaty.

To claim the "closer connection exception" under the Code, you have to establish that you:

- Maintain a permanent home in Canada (no need to own; you only need continuous access), as well as personal belongings
- Have family in Canada
- Are employed or carry on business in Canada
- Do banking and hold investments in Canada
- Vote in Canada
- Participate in social or religious organizations in Canada

You cannot, however, claim this exception if you spend more than 183 days in the U.S. in the current year or if you have applied for a green card.

The "Tie-breaker" Rules

If you can't claim the closer connection exception, there are "tie-breaker" rules under the Canada-U.S. Tax Treaty which take you through a series of tests.

First, if you have a home available to you only in Canada, you can claim residence here. However, the likelihood is that you may also own property in the U.S., so you would have to look at the next test.

This next test focuses on where your centre of vital interest lies (i.e., where your personal and economic relations are closer to) and claim residence in that jurisdiction. Note that there is no hard or fast test to answer this question. Rather, you need to show that all sorts of factors go into proving that your centre of vital interests lies in Canada.

Next, if your centre of vital interests cannot be determined, you will be resident where you have your habitual abode. If that happens to be in both countries (or in neither), then you will be deemed resident in the country of which you are a citizen. Finally, if you are a citizen of both countries (or neither), then the U.S. and Canada will mutually settle the question for you.

Note: You will be subject to certain filing requirements in the U.S. in order to claim any of the above exemptions. Care should be made to ensure you have filed the appropriate forms and that they have been filed by the deadlines.

Rental Income

If you own a second home in the U.S., chances are that you may be renting it out during the off-season to help offset costs (especially if the home is sitting empty for that part of the year).

However, if you do this, be aware that in the U.S., withholding tax of 30 per cent normally applies to the gross rent paid to you. Unfortunately, this withholding tax is not reduced by the Canada-U.S. Tax Treaty (unlike withholding taxes on interest and dividends).

You can avoid this tax by voluntarily filing a U.S. tax return and electing to pay the tax on the net rental income. It may be advisable to take advantage of the net rental income election if you incur expenses in respect of your U.S. rental property, such as mortgage interest, maintenance, insurance, property taxes etc., by deducting these expenses. Yes, you can deduct mortgage interest payments in the U.S. on your home or vacation property.

This election can apply for future years and to all of your rental real estate in the U.S. On your U.S. return (1040NR) you would show the income and expenses, as well as the amount of tax withheld.

This may also allow you to receive a refund for any taxes withheld (to the extent the withholding amount exceeds the tax payable). To make the net income election you must file a 1040NR, including a statement declaring that you are making the election. It should include the address of the property and your percentage ownership.

The 1040NR is due by June 15th of the year following the calendar year in question (subject to any extensions). Once the election is made, you should provide Form 4224 to your tenant and the 30 per cent withholding will not be required.

Sale Proceeds

If you decide to sell your "home away from home", a withholding tax of 10 per cent of the gross sale price is normally payable under the Foreign Investment in Real Property Tax Act ("FIRPTA") at the time of sale.

In addition, you will still be required to file a U.S. tax return for the year of sale as the U.S. has the right to tax non-residents on the sale of real property in the U.S. The tax withheld under FIRPTA may be offset against the U.S. income tax payable on any gain realized on the sale (or refunded if it exceeds the income tax liability) that you will have to report in your

U.S. tax return. Note, however, that the tax under FIRPTA may be reduced or eliminated in certain circumstances:

There is no withholding requirement where (a) the purchase price for the property is under US$300,000, and (b) the property is acquired by the purchaser as a home, with actual plans to reside in it for at least 50 per cent of the time that the house is occupied in the first two 12 month periods after purchase.

The withholding tax can be reduced if you obtain a withholding certificate from the IRS on the basis that the expected U.S. tax liability on the gain will be less than 10 per cent of the sale price. The certificate will indicate the reduced amount of tax that should be withheld.

On a sale of your real estate, you will need to provide an Individual Taxpayer Identity Number ("ITIN") to the transfer agent, even if there is no withholding tax due.

The sale cannot close without both the vendor and purchaser providing an ITIN. In addition the IRS will not issue a receipt for the withholding tax paid unless both the vendor and purchaser provide an ITIN. An ITIN can be obtained by filing Form W-7 with the IRA. This can be at least a six week process.

Avoiding U.S. estate tax has become a highly discussed topic

As mentioned above, if you sell your real estate, you will have to file a U.S. tax return to report the gain (with a credit that may be claimed for tax withheld under FIRPTA). If you have owned the property since before September 27, 1980, you can take advantage of the Canada-U.S. Tax Treaty to reduce the gain.

In this case, you will only have to pay tax on the gain that accrued since January 1, 1985 (this does not apply to business properties that are part of a permanent establishment in the U.S.). To claim this treaty benefit, you have to make the claim on your U.S. tax return and include specific information about the sale.

Any U.S. tax paid on the sale of the property will generate a foreign tax credit which you can use to reduce your Canadian tax on the sale (courtesy of the Treaty). Note: This tax credit may be limited if you use your principal residence exemption to reduce your Canadian gain.

U.S. Estate Tax

If you continue to own the U.S. property until you pass away, you will be subject to U.S. estate tax, which in the past has ranged from 18 per cent to as high as 55 per cent (Back in 2010, the U.S. estate tax regime was repealed for that one taxation year).

Currently, the U.S. estate tax rate ranges from 18 per cent (where value is less than US$10,000) up to 40 per cent (on amounts exceeding US$1,000,000) on the fair market value of your U.S. property.

However, there is currently a US$5.34 million exemption available for U.S. estate tax for U.S. residents/citizens. Fortunately, under the Treaty, Canadians are allowed similar treatment, although you must prorate the value of your U.S. property against the value of your worldwide estate.

Essentially, Canadians are able to take advantage of a unified credit which can reduce or even completely shelter the U.S. estate tax payable. This credit uses as a baseline the U.S. estate tax that would be payable on US$5.34 million of assets, being $2,081,800. Accordingly the unified credit is calculated as being equal to the greater of US$13,000 and US$2,081,800 times.

So, if your U.S. assets represent 20 per cent of your worldwide assets, you would be entitled to a credit equal to US$416,360 ($2,081,800 times 20 per cent). Note: The Treaty also provides for a marital credit where property is left to a surviving spouse

Avoiding U.S. estate tax has become a highly discussed topic in Canada over the years. The CRA's announcement in 2004 clamping down on so-called "single purpose" corporations meant that U.S. estate-tax-avoidance strategies have had to be rethought.

For example, the use of non-recourse debt may reduce the value of the property for estate tax purposes in the U.S. since the lender's only recourse is to foreclose on the property.

So if a non-recourse debt is outstanding at the time of death, the debt may reduce the value of the property, dollar for dollar, thereby reducing the value of the property for U.S. estate tax purposes. Accordingly, one may want to consider speaking to your financial institution about putting a non-recourse debt in place.

An alternative option could also involve holding the U.S. property through a trust. This

has become a more popular alternative. A Canadian resident trust would be formed and structured in such a way that while the U.S. property is in the trust, no U.S. estate tax is payable.

The downside, however, is that since a Canadian resident trust is deemed to sell all of its assets on every 21st anniversary of the trust, there could be a Canadian capital gain tax hit if the property has grown in value.

Accordingly, for Canadian purposes, it is important that the property be distributed out of the trust prior to its 21st anniversary. Therefore, the use of a trust really only defers U.S. estate tax to future generations who are beneficiaries of the trust. Note – even though the trust would be a Canadian trust, you should obtain U.S. tax advice to ensure it contains the proper drafting to avoid U.S. estate tax during the lifetime of the trust.

On a happy note, if the U.S. situs property is a true rental investment (and not a personal use property), ownership of the property in a Canadian holding company may still be an option – but if the property is personal use, then this option could result in Canadian tax to you.

My advice: even though it would never occur to you to talk to your tax advisor when buying a U.S. home, doing so could help you properly structure the ownership of the U.S. property and avoid, or at least defer, U.S. estate tax. ❒

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