SNOWBIRDS: U.S. TAX ISSUES YOU WON'T BE ABLE TO FLY AWAY FROM*

Samantha Prasad, Associate, Minden Gross

*(*This release is based on an article published in the TaxLetter, May 2004, MPL Publishing)*

If you are one of the lucky snowbirds who spend your winters in sunny Florida, you're probably already settled back in at home here in Canada, getting ready for the summer. But you should be aware of certain U.S. tax issues that might follow you home back to Canada. The following is a brief summary of some of the key tax issues that may affect your warm sunny lifestyle:

Residency

Although you may consider yourself a resident of Canada, and you've already duly filed your Canadian tax return as you do every year, you should be aware that the U.S. may still consider you a U.S. resident. If this is the case, 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.

If you are a Canadian snowbird, you will be resident in the U.S. if you meet either 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.

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., calculated 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 1/3 of the days you spent in the U.S. in the last year, plus 1/6 of the days you spent in the U.S. in the year before last equals or exceeds 183 days.

You can, therefore, spend up to 120 days each year in the U.S. without crossing this threshold test. In calculating the number of days, you should be aware 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 in the U.S.

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

If you are considered a U.S. resident you can try to either claim the "closer connection exception" allowed under the Internal Revenue Code (the Code) or you claim a treaty exemption.

To claim the "closer connection exception", you have to establish that you have closer connections to Canada, such as:

- maintaining a permanent home in Canada (no need to own; you only need continuous access), as well as personal belongings
- having family in Canada
- being employed in Canada, or carrying on business in Canada
- banking, and holding investments, in Canada
- voting in Canada
- participating 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 you have applied for a green card.
You must also file Form 8840 under the Code to claim the closer connection exception (you don't need a U.S. tax identification number).

If you can't claim the closer connection exception, there are "tie-breaker" rules under the Canada-U.S. tax treaty. For example, if you have a home available to you in Canada, you can claim residence here. If, however, you have a home in both Canada and the U.S., then you would look to see where your centre of economic interest lies, and claim residence in that jurisdiction. However, you will still be subject to the filing requirements under the Code (U.S. Tax return, Form 1040NR).

To claim a treaty exemption, you have to complete Form 8833 and attach it to Form 1040NR. You must explain in the Form 8833 that you are a resident of Canada and are not subject to regular U.S. income tax rates on U.S. source income under the Canada-U.S. tax treaty.

Form 8840 (to claim the closer connection exception) and the 1040NR with Form 8833 (to claim a treaty exemption) must be filed by June 15th of the following year. For 2003, you must file either Form 8840 or the 1040NR and Form 8833 by June 15, 2004. If you have income subject to U.S. withholding tax such as employment income, the filing deadline is April 15th of the following year. You can file Form 4868 by the due date to get an automatic 4 month extension to file Form 1040R. If you still need an extension beyond that, you can file Form 2688 to apply for an additional 2 month extension. Any tax payable, however, must still be paid by the original due date. No extension is available for Form 8840. If you fail to file the above forms in the appropriate circumstances by the due date, you will be subject to penalties, which can be as much as $1,000 for each item of income involved (the Canada-U.S. tax treaty does not protect you from these penalties).

Property Ownership

Rental income

Snowbirds who own real estate in the U.S. and rent it out while they are back in Canada should be aware that withholding tax of 30% normally applies to the gross rent paid. This withholding tax is not reduced by the Canada-U.S. tax treaty (unlike withholding taxes on interest and dividends). You can avoid this withholding 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 such expenses. This election can apply for future years and applies 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. The election should include the address of the property and your percentage ownership. As noted above, 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% withholding will not be required.

Sale proceeds

If you sell your U.S. real estate, a withholding tax of 10% of the gross sale price is normally payable under the *Foreign Investment in Real Property Tax Act* ("FIRPTA"). The tax withheld 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). The tax under FIRPTA may be reduced or eliminated in certain circumstances:

1. There is no withholding requirement where (a) the purchase price for the property is under $300,000(U.S.), and (b) the property is acquired by the purchaser as a home, with actual plans to reside in it for at least 50% of the time that the house is occupied in the first two12 month periods after purchase.

2. 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% 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. This applies to all dispositions of real property after November 3, 2003. This is so, 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 is at least a 6 week process.

If you sell your real estate, you will have to file a U.S. tax return to report the gain (a credit may be claimed for tax withheld under FIRPTA). This filing requirement is true even where there is no withholding tax due. (This is a change from the previous situation where there was no filing obligation in the absence of a withholding requirement.) The capital gains rate in the U.S. is currently 15%. If you have owned the property since before September 27, 1980, you can tax 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. This tax credit may be limited if you use your principal residence exemption to reduce your Canadian gain.

Miscellaneous tax tips

A number of other Canadian tax rules may be of particular interest to snowbirds:

- You can claim eligible medical expenses paid for yourself, your spouse or a dependent for Canadian tax purposes, even if you pay them in the U.S.

- Premiums paid to private insurers in the United States for medical and health care coverage are qualified medical expenses for Canadian tax purposes.

- The principal residence exemption is available in respect of residential properties located anywhere in the world. If you have residential properties on both sides of the border, you can elect in respect of the property that provides the greater benefit.

Gifts to U.S. charities generally are allowed tax credits for the purposes of computing Canadian tax to the extent of the 20% limitation applied to U.S. source income.