U.S. TAXATION

Wednesday, JANUARY 7, 2015

Tax basics

- Canadian tax is based on residency
- Residents of Canada are taxed on World Income in Canadian Funds
- Pay tax in province of residency as of December 31
- U.S. residents and citizens are taxed on World income in U.S. dollars
- Pay tax in state of residence and possibly other states as well
- Foreign Tax Credits are available in both countries

Filing requirements

- Most Canadian residents must file income tax returns and pay any taxes owing by April 30th of the following tax year
- If self-employed, Canadian residents have an extension for filing until June 15th of the following tax year
- U.S. residents are required to file and pay their income tax due by April 15th of the following tax year; U.S. citizens & residents living outside the U.S. with no U.S. employment income get an automatic filing extension to June 15th
- Interest will accrue in both countries on taxes owing after the payment due dates and potential late filing penalties may be applied for late filed returns
- U.S. green card holders are still treated as U.S. taxpayers as long as they hold the green card (expired or not)

Additional U.S. filing requirements

- Foreign Bank Account Reports (FBARs) – due June 30th
- Investment in Foreign Trusts (3520 & 3520-A) – due March 15 & due date of tax return
- Statement of Foreign Financial Assets (8938) – due with tax return
- Investment in Foreign Corporation (5471 & 5472) – due with tax return
- Investment in PFICs (8621) – due date of tax return

These are only some of the additional filings required, not all! All have minimum $10,000 penalties for non-compliance.

TOPICS OF INTEREST

- Look through provisions for personal services
- Real property gains
- Portfolio gains
- Mutual funds
- Pensions & annuities
- New U.S. net investment tax
- U.S. rental property
- Basics of owning U.S. property
  - PRE
  - Ownership structures
- U.S. gift & estate tax

Look through provisions

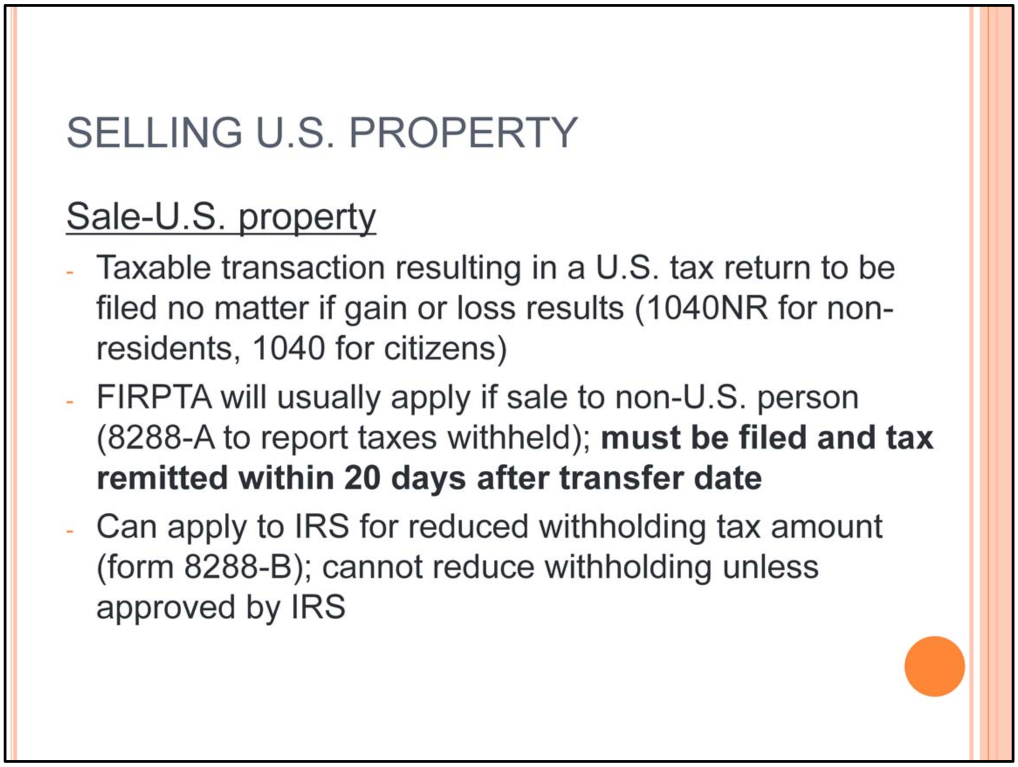
- There are certain types of professions/services that the IRS does not allow a taxpayer to shelter in a corporation, medical services are one of them
- If a U.S. medical doctor incorporates and is the only doctor within the company, these personal services will be seen as still being earned personally and the IRS will "look through" the company and deem any profits remaining in the corporation to be earned as a dividend by the U.S. shareholder in accordance with their proportionate share in the company (i.e. subpart F income)
- Double taxation exists if dividends are not received in Canada and sufficient tax paid on those dividends for use as a foreign tax credit

Subpart F example

- Gerry is a U.S. citizen living in Canada and has been practicing as a doctor for the past 10 years
- 3 years ago he decided to incorporate himself in Canada to benefit from the small business tax rates; he is the sole shareholder
- Assume in 2013, profits after tax in the corporation were $135,500, which included a $100,000 salary deduction for Gerry and no dividends were paid
- U.S. rules look through the company and deem Gerry to earn the $135,500 personally as a dividend, which means he will pay tax in the U.S. on this income and have no offsetting tax from Canada (i.e. double taxation results because he will eventually draw the money as a dividend in a future year and pay tax in Canada but cannot claim the tax paid in the U.S. as a credit as it is not U.S. source income)

Real property Gains

- Gains on disposition of real property may be taxed in both countries even if property only held in one country
- In U.S. means – U.S. real property interest except share of capital stock of company not resident in U.S.
- In Canada means – CDN real property interest including a share of capital stock of company resident in Canada, interest in partnership, trust or estate
- Article XIII:6 allows bump up in cost base for U.S. tax on principal residence upon emigration from Canada (only if not U.S. citizen)



FIRPTA results in a 10% withholding tax applicable on the gross proceeds unless the exceptions are met; purchaser is the agent required to withhold.

Main exceptions to FIRPTA withholdings:
- Sale proceeds are under $300,000 and it is being used as your home (you or a member of your family must have definite plans to reside at the property for at least 50% of the number of days the property is used by any person during each of the first two 12-month periods following the date of transfer. When counting the number of days the property is used, do not count the days the property will be vacant)
- A withholding certificate is provided that reduces the withholding tax (form 8288-B approved by the IRS)

SELLING U.S. PROPERTY (CONT'D)

Sale-U.S. property

- ITIN needed to file (purchaser and seller) (W-7 form), unless US # already issued
- Must ensure that the proper forms are filed in the U.S. in a timely matter in order to receive refund of taxes within reasonable time frame
- Ensure proper taxpayers are filing the forms
- Disposition also must be reported on the Canadian T1 return, FTC can be claimed for any tax paid in the U.S.

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FIRPTA EXAMPLE

Sale-FIRPTA example

- Danny sold his Florida vacation home to another Canadian who also plans to use it as a vacation home
- Sales price was $375,800 and ACB was $215,000
- FIRPTA withholding is $37,580
- Danny is required to file a 1040NR to report his $160,800 capital gain, which is 100% taxable
- Taxes owing are only $24,120 (15% rate), which means he will receive a refund of $13,460 (no Florida tax)

FIRPTA EXAMPLE (CONT'D)

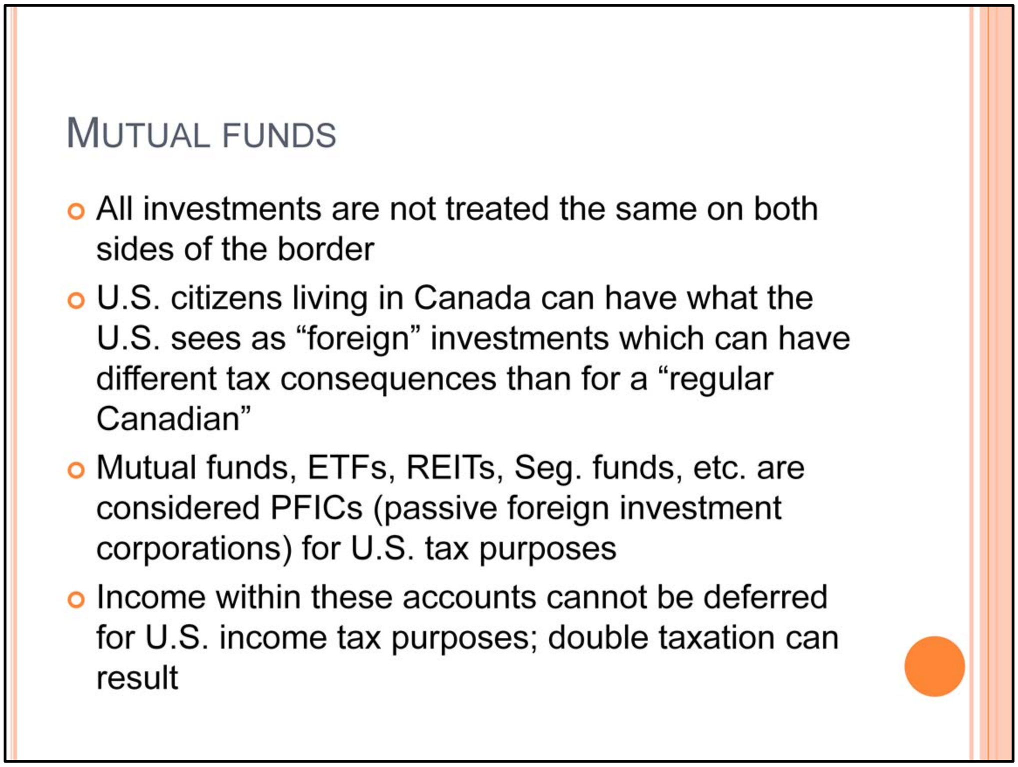
Sale-FIRPTA example

- Danny will have to report the gain on his Cdn return as well but the amount of the taxable gain is only $80,400
- Danny can use the $24,120 as a FTC on his Cdn return against the taxes applicable in Canada on the gain; depending on his tax bracket, he may have excess FTCs or a shortfall; shortfall means tax owed to Canada
- The U.S. property may qualify for PRE from a Cdn perspective but not likely in the U.S. so if FTCs cover taxes in Canada, no need to waste PRE

Portfolio gains

- Gains on non-registered investments are generally earned outside a country's tax system
- Under Treaty, gains from dispositions of publicly traded securities are only taxed in the country of residence (Article XIII:4)
- This is why non-U.S. citizens do not file U.S. tax returns to report the disposition of U.S. stocks

Note: Dividends from U.S. stock are considered U.S. source income so if correct withholding tax is not taken, technically a U.S. return should be filed to account for the appropriate amount of tax.



- Separate reporting requirements for each separate fund (form 8621)
- Compliance fees can be significant and potential penalties can be HUGE ($10,000 per return)
- Inclusion of income in the U.S. but not in Canada generates the potential for double taxation

Pensions & annuities

- May be taxed in both countries but excluded amounts from payer country also excluded in country of recipient's residency
- Reduced withholding of 15% if periodic pension payments or annuity payments
- Social security only taxable in country of residence
- Canada allows 15% exemption for U.S. social security
- Contributions to employer sponsored retirement plans in other country are deductible against income (not RRSPs) if deductible in source country
- Tax-free rollover of US pension into Cdn RRSP is possible but **tax results immediately in the U.S. and penalties can result for early withdrawal**

Early withdrawal penalty is 10% of taxable pension withdrawal

NEW INVESTMENT TAX

- From Jan. 1, 2013 onward, the IRS has introduced a new 3.8% net investment tax for U.S. citizens and residents who meet specific tests
- Individuals will owe the tax if they have net investment income and also have modified adjusted gross income over the following thresholds:

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000

Taxpayers should be aware that these threshold amounts are not indexed for inflation.

This will almost always be an issue for U.S. incorporated doctors subject o the look through provisions

U.S. RENTAL PROPERTY

Vacation home – U.S. rental

- Renting a vacation home/condo changes the use from personal to business or visa versa
- Deemed disposition on change of use in Canada; taxes can result
- No deemed disposition in U.S. = mismatch of taxes
- In U.S., gain/loss is apportioned between personal and business use when property actually sold (i.e. paper disposition still calculated but not reported until sold)

U.S. RENTAL (CONT'D)

- Rental income and expenses must be reported on your Cdn and U.S. tax returns
- 30% withholding tax on gross rents in U.S.
- Can elect to treat rental income as effectively connected with trade or business in U.S. to avoid 30% withholding tax (W-8ECI) (ONLY IF NOT U.S. CITIZEN)
- File 1040NR to claim net profit or loss, pay tax when return due; FTC in Canada (1040NR due June 15, tax due April 15)
- Depreciation is mandatory in U.S. at full rates; losses carry forward for use against future income or gain on sale
- Depreciation limited to profits in Canada (cannot create or increase rental loss)

U.S. RENTAL EXAMPLE

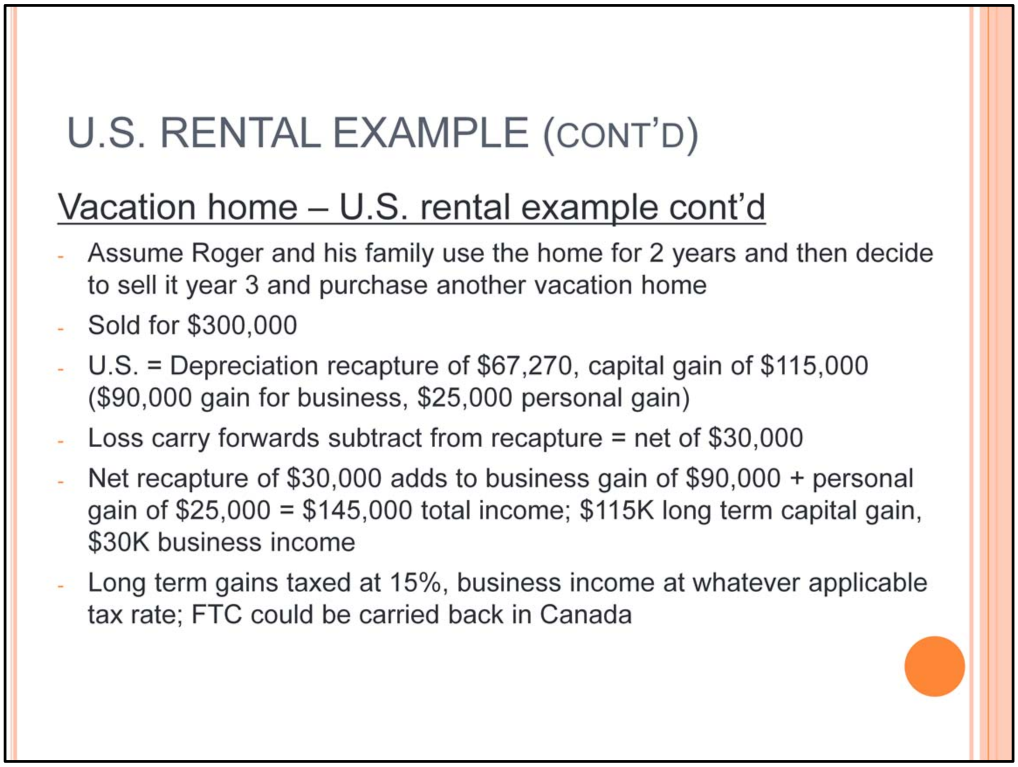
Vacation home – U.S. rental example

- Roger wants to rent his vacation home for 10 years until he retires and then he and his family will use it themselves
- Assume Roger receives $15,000 in rental income and incurs $12,000 in expenses each year before depreciation
- Property ACB is $185,000, making depreciation $6,727/yr (27.5 yrs SL rate) and he bought property on Jan 1 of year 1
- Net loss each year is $3,727; total over 10 years is $37,270
- Assume FMV in year 11 is $275,000 when he stops renting
- Change in use will deem disposition in Canada, resulting in capital gain of $90,000; $45,000 taxable

U.S. RENTAL EXAMPLE (CONT'D)

Vacation home – U.S. rental example

- Assume $3,000 depreciation claimed in Canada for each of the 10 years; $30,000 recapture taxable in Canada
- Because no taxable event in U.S. in year of change, no FTCs available for use on Cdn return; double taxation results unless FTCs available for carryback to deemed disposition year
- FTCs can be carried back 3 years in Canada and forward 10 years
- FTCs can be carried back 1 year in the U.S. and forward 10 years



- creating tax on the $30K deferral of business income because depreciation is mandatory (personal exemption of $3,900 would have covered small profits if claimed in year realized); ACTUALLY END UP LOSING IN U.S. (i.e. you pay tax on more income)

- If loss before depreciation, losses get deferred and deducted against gains in year of sale; WINNING SITUATION IN U.S. (i.e. you pay tax on less income)

U.S Properties

- P.R.E.
- How is it owned?
- What is long-term goal
- Gift/estate tax issues

P.R.E IN THE U.S

- Only shelters $250,000 gain ($500 K for married joint filers)
- Property must meet principle residence test 2 out of last 5 years (not as lenient as Canada)
- Can only use every 2 years
- Only individuals, granter trusts and other single – owned entities can use P.R.E

Gain over exemption is subject to long term capital gain rates.

- tax brackets:
    - 15% or lower – 0%
    - 25%-30% - 15%
    - 39.6% - 20%
- 2013 and forward, gains over limit also subject to new 3.8% net investment tax.
- If more than 1 home is owned, IRS can look at the following to determine if P.R test is met:
    - Length of occupancy
    - Taxpayer's place of employment
    - Address on driver's license
    - Auto and voters registration
    - Mailing address

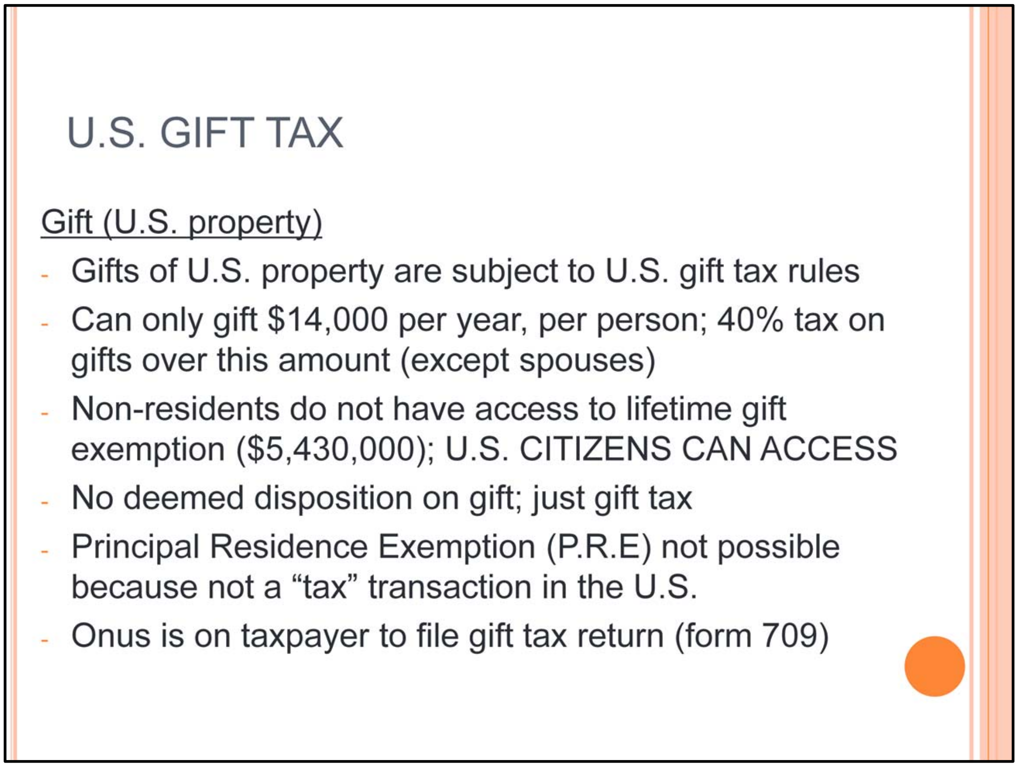
Ownership

- Joint tenancy
- Joint tenants with right of survivorship
- Tenants – in – common
- Trust, corporation or individual

Joint tenancy and joint tenancy with rights of survivorship means title transfers to surviving owner but also means 100% value used for U.S estate purposes unless can prove other person paid for his or her share of the property.

Tenants – in – common
- Only % share included in U.S estate value and share transfer to beneficiaries not other owner.

Grantor trust rules deem trust to still be owner by grantor for income tax and estate tax purposes.



If the property is U.S. situs real estate, the transferor should be aware that U.S. Gift Tax can apply. A Canadian non-resident taxpayer does not have access to the U.S. Lifetime Gift Tax Exemption and would therefore be limited to an annual Gift Tax Exemption of $14,000 per year per person.

Gifts between 2 U.S. spouses have no limit, gifts between U.S. citizen and non-U.S. citizen spouse are limited to $154,000 per year.

Also, gifting U.S. property does not create a deemed disposition for U.S. tax purposes, but it would result in a deemed disposition for Canadian tax purposes. The U.S. Gift Tax is not creditable against Canadian income taxes, which might arise on the deemed disposition. This could potentially result in “double tax”.

U.S. GIFT TAX (CONT'D)

Example – gift tax

Jerry and Shirley bought their U.S. vacation home as joint tenants-in-common but now their son wants to become part owner

- They were going to each gift half of their ownership to their son and just add his name to the title document until they realized they would have to pay U.S gift tax
- Their U.S property has a FMV of $400,000 ($200K each)
- If they each gift $100K, they will have to pay $34,000 in gift tax (($100K-14K)x40%) & file form 709

AVOIDING U.S. GIFT TAX

- A sale can be structured to avoid U.S. gift tax
- For example:
  - Cindy and Roger want to transfer title of their U.S. vacation home over to their son Mike; ownership is currently JTC
  - FMV of the property is $135,000
  - Mike signs a sales agreement with his parents and they take back a promissory note from Mike for $135,000 with terms that require him to repay the note over 5 years ($27K/yr)
  - Cindy and Roger can gift the annual payments to Mike without gift tax issues because each gift is under $14,000
  - Still a taxable transaction and reportable in the U.S. on a 1040NR (i.e. simply no cash changes hands) & Canada on T1; if gain tax may result

- This would be an installment sale for U.S. purposes

U.S Estate Tax

- All U.S property applicable to this taxes
- 40% Estate tax on amount over exemption
- Estate tax exemption currently $5,430,000
  - Prorated for non-resident/non-citizenship
  - If worldwide net worth lower than $5,430,000 never owe U.S. estate tax ($5,340,000-2014)
  - U.S gift and estate tax only applies to individuals

U.S Estate Tax (cont'd)

Example 1 – estate tax

- use same scenario for Jerry and Shirley but ignore gift to son

- If Jerry died in 2014 while still owning the U.S property and its FMV was $400K, his U.S estate value would be $200K (assume no other U.S assets)

- Jerry's world-wide net worth is $3,735,000
- No estate tax due in U.S because his prorated portion of exemption covers property value.

$$\frac{\$200K}{\$3{,}735K} \times 5{,}340K = \$285{,}944$$

$285,944 –$200,000 = No estate tax

U.S Estate Tax (cont'd)

Example 2 – estate tax

- Marc & Lori own their U.S. condo as joint tenants in common and it currently has a FMV of $600,000
- If Lori died in 2014 while still owning the U.S property and we assume no other U.S assets, her US net worth would be $300,000
- Lori's world-wide net worth is $5,735,000
- Estate tax is due because her prorated portion of exemption does not cover the U.S. property value.

$$\frac{\$300K}{\$5{,}735K} \times 5{,}340K = \$279{,}337$$

$$\$300{,}000 - \$279{,}337 = \$20{,}663$$

$$\$20{,}663 * 40\% = \$8{,}265 \text{ (estate tax)}$$

FROSTIAK & LESLIE
Chartered Accountants Inc.
www.cafinancialgroup.com

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Questions?

Thank you!

Angela D. Preteau, CA, CPA
Frostiak & Leslie Chartered Accountants Inc.
(204) 487-5204
apreteau@cafinancialgroup.com

Winnipeg - Head Office Toll free 1.888.978.7500
200 - 1700 Corydon Avenue • Winnipeg • Manitoba • Canada • R3N 0K1 • Tel: 204.487.4449 • Fax: 204.488.8658
Branch Offices (Manitoba): Gimli • Niverville • South Junction • Winkler
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