

The U.S. TAXFAX

TOPIC: MOVING TO THE UNITED STATES – PART 1

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This edition of the U.S.TAXFAX will discuss some of the income tax related issues an individual should take into consideration when contemplating a move to the United States.

We have noticed an ever increasing number of individuals departing Canada and moving to the United States. Potential emigrants usually assume that they will pay less tax in the United States than in Canada and many times this is the primary motivation for the move in the first place. While this is generally true with respect to income taxes, there are many non-tax factors to consider which we will address in the next edition of the U.S.TAXFAX. It is also important to determine whether the benefits of departing Canada outweigh the costs associated with becoming a non resident.

Residency:

As noted earlier, many moves to the United States are income tax motivated. In order to realize the benefits of the lower U.S. tax rates, the individual must clearly be able to demonstrate that he is a U.S. resident and a non resident of Canada. In order to determine the country of residency, provisions of the Canadian Income Tax Act, the Internal Revenue Code, and the Canada – U.S. Income Tax Convention (the “Treaty”) must be considered. Generally, if the individual has a home in the U.S. **and** his social and economic ties are more closely associated with the U.S. than Canada, he will be considered a U.S. resident and, consequently, a non resident of Canada. Examples of social and economic ties that must be considered include the principal residence, bank

accounts, social and religious affiliations, and medical and health care coverage.

The Canadian departure tax regime must also be reviewed to ensure that the costs of becoming a non resident do not exceed the benefits. If the individual does not plan to be in the United States for an extended period of time and/or the departure taxes are significant, it may be more cost effective to arrange his affairs so that Canadian residency is maintained while living in the U.S..

Canadian Tax Consequences:

An emigrant must report worldwide income through the date that Canadian residency ceases. Choosing a departure date is important as it is often possible to split income between Canada and the U.S. to take advantage of the lower marginal rates in both countries. Once non-resident, only Canadian source income is taxable in Canada.

There are circumstances where Canadian taxes on income may be less than the U.S. taxes on the same income. In these instances, it is important to realize the income prior to establishing U.S. residence. An example of this would be the payment of a retiring allowance by an employer that is eligible for transfer to a RRSP in Canada. If it is received prior to establishing U.S. residency, the retiring allowance will not be subject to U.S. tax.

Another issue that requires consideration is the departure tax rules. Generally speaking, an individual is deemed to dispose of all assets at fair market value on the date that Canadian residency ends. This means that accrued gains on these assets will be taxable on the final Canadian return. The deemed disposition rules do **not** apply to assets such as Canadian real estate and RRSP’s as these assets

will be taxable in Canada when they are eventually disposed of or withdrawn. Another exception to the general rule is for short term residents - defined as individuals who have not been resident in Canada for more than 60 months in the past 10 years. Short term residents are not subject to the deemed disposition rules on property they owned prior to attaining Canadian residence.

A question that often arises is the taxation of RRSP's upon emigration. It is usually recommended that an individual maximize RRSP contributions in the year of departure. If the individual requires the funds, he may withdraw the contribution as soon as he becomes a Canadian non resident and be subject to a 25% Canadian withholding tax on the withdrawn amount. As the original contribution saved the taxpayer up to 53% in taxes, immediate tax savings of up to 28% would result.

Often times, the taxpayer does not dispose of his principal residence prior to leaving Canada. If the home is rented while a non-resident, elections are available which would not deem a change of use and therefore a taxable event to take place upon conversion of the property from personal to business use. This election allows the taxpayer to reoccupy the home as a principal residence upon returning to Canada without paying tax on the appreciation of the property during the period of non residence. Don't forget that the gross rental income earned while a non resident is subject to Canadian withholding tax provisions. In most cases, the 25% withholding tax may be reduced or eliminated by making application to Revenue Canada.

U.S. Tax Consequences:

The individual must report worldwide income on a U.S. income tax return from the date that he establishes U.S. residence. There are elections that can be filed in the first year of residency that allow the individual to file a joint tax return for the year or to be treated as a resident for the whole year. The benefits of making either one of these elections vary depending on the circumstances of the particular individual.

The treaty also provides U.S. tax relief with respect to RRSPs established while a Canadian resident.

Normally, income earned in the RRSP is taxable in the U.S. on an annual basis. However, an election can be filed with the U.S. income tax return each year that defers tax on the income until funds are withdrawn from the RRSP.

The tax basis of assets (tax cost used for capital gains purposes) is another area that requires review by taxpayers emigrating to the United States. The U.S. values assets (some exceptions apply) at historical cost, not the fair market value on the date U.S. residency is established. This can result in double taxation if Canada deems a disposition at fair market value to take place on the date of departure. As a result, it may be advisable to realize gain on appreciated assets prior to departure from Canada. Conversely, it generally makes sense to hold assets with inherent losses until U.S. residence is established.

The Treaty provides relief from the tax basis problem in certain situations. For example, an emigrant's principal residence prior to the move is allowed a step up in U.S. cost basis to the fair market value on the departure date.

State Taxes:

State taxes are another factor often overlooked. Some States (e.g. Washington, Florida, Texas, and Nevada) do not have State individual income taxes while others such as California have tax rates as high as 9.3%. While these taxes are usually deductible on the U.S. federal return, they do represent an additional level of income tax.

Due to the complexity in this area, we have been able to touch on only a few of the more common issues encountered. As each scenario is unique, it is important that professional advice be sought prior to making a final decision on whether to move to the United States.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained.