Kotler van den Brink & Company
U.S. & International Tax Consultants

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The U.S. TAXFAX

TOPIC: U.S. TAX CONSEQUENCES OF MOVING TO CANADA FROM THE U.S.

This edition discusses the U.S. tax consequences for individuals moving from the U.S. to Canada. The discussion assumes that the individual is not a U.S. citizen. The Canadian tax consequences of a move to Canada will be addressed in a future edition.

We have noticed an increasing number of people moving back to Canada as the U.S. economy slows. As will become clear, it is important that the various tax planning options be considered prior to the move.

Generally speaking, an individual departing the U.S. is required to pay tax on worldwide income up to and including their residency termination date. Only U.S. source income is subject to U.S. tax after this date. The residency termination date is determined differently for those with permanent residency status (i.e. green card holders) from those with temporary work visas.

In most cases, the residency termination date for those with temporary work visas is the last day that an individual is physically present in the United States. The residency termination date for green card holders is usually the date the green card is surrendered. There are many exceptions and variations to these general rules and as such the termination date is often the most difficult issue to resolve.

One exception to the residency termination date rules is for long term green card holders who terminate their residency with a principal purpose of tax avoidance. This provision is only applicable for individuals whose net worth exceeds $500,000.00 or for those whose tax liability for the preceding 5 years exceeded $100,000.00. A tax avoidance motive is assumed if the individual held a valid green card for 8 of the past 15 taxable years before surrendering it. Individuals caught under these rules are subject to U.S. tax on most capital gains for 10 years from the date the green card is surrendered. There are exceptions made for individuals who move back to their country of origin, however, a ruling from the IRS must be obtained.

Issues that we encounter on a regular basis and which should be considered are as follows:

Filing Status:

One of the benefits of living in the U.S. is the ability to file joint tax returns with a spouse. This often reduces the tax liability for single wage earner families. Unfortunately, joint filing status is not available in the year of departure. This often creates a tax liability on the departure year return, especially if the employer was withholding tax at source on the assumption that a joint return would be filed.

One solution to this problem is to delay the departure date until just after the year end (i.e January 1). Delaying the departure date ensures that a small amount of income will be taxed on separate departure returns while still allowing the couple to file jointly in the preceding year. This can be especially beneficial for those contemplating a move later in the year.

Another solution for married couples forced to file single returns is to consider filing under the

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community property rules. This option is only available if the family resided in a community property state such as California or Texas prior to departure. The community property provisions allow a married couple to effectively split income and deductions equally and report 50% of the income and deductions on their separate returns.

Principal Residence:

The U.S. exempts from tax $250,000.00 ($500,000 for joint filers) of capital gain on the sale of a principal residence as long as this property was used as a principal residence for more than 2 of the past 5 years. Unfortunately this exemption is only available to U.S. residents. If a previous principal residence is sold after the departure date, 100% of the capital gain will be taxable on the U.S. return (keep in mind that the U.S. taxes non-residents on gains from U.S. real estate transactions).

One solution to this problem is to delay the departure date for U.S. purposes until after the principal residence is sold. This is not always possible, as a new job often requires a move prior to the disposition. Another alternative is to transfer the property to another entity (such as a corporation) before moving back to Canada.

Deemed Disposition Rules:

Unlike Canada, the U.S. does not have comprehensive deemed disposition rules upon departure from the United States. This means that a move back to Canada will not trigger any U.S. taxes on appreciated property held on the departure date. As long as the assets are not U.S. real estate based, the U.S. will not tax any gain when the asset is eventually sold. This is assuming that the individual is not considered to have terminated residency with a principal purpose of tax avoidance (see above). As Canada bumps the cost basis of most assets to fair market value upon entry to Canada and since the U.S. does not tax an accrued gain on departure or when it is sold it is often possible to avoid U.S. and Canadian tax on gains accrued to the departure date.

Another planning point that should be considered is whether or not to dispose of assets with an accrued loss prior to the departure date. By disposing of the loss asset prior to departure, an individual can realize a capital loss and offset any capital gains with this loss. Keep in mind that for U.S. purposes the loss can not be carried back but it can be carried forward indefinitely and possibly used in a future year.

U.S. Trusts:

If the departing individual has set up a U.S. trust while a resident of the U.S. or is a trustee of a U.S. trust, it is important that the terms of the trust be reviewed. A trust is usually considered resident of the country in which the trustee is resident. If the trustee departs the U.S. and the residency of the trust changes, negative tax consequences can arise. It is often beneficial to appoint U.S. trustee(s) prior to departure.

RRSP's:

In many cases the individual moving to Canada has accumulated RRSP's during a previous period of Canadian residence. It is often in the individuals best interests to withdraw these RRSP's prior to establishing Canadian residence. This can ensure a flat 25% Canadian tax on the withdrawal versus being taxed at the Canadian marginal rates if the RRSP is collapsed while a Canadian resident. The U.S. only taxes income earned in the RRSP account from the date the individual became a U.S. resident. The U.S. allows the Canadian taxes paid as a foreign tax credit on the final return and therefore in many cases there is no additional U.S. tax resulting from the withdrawal.

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 moving back to Canada.

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.