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

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The U.S. TAXFAX

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

This edition of *The U.S.TAXFAX* discusses the Canadian tax consequences for individuals moving to Canada from the United States. As you may remember, the November 2001 edition discussed the U.S. tax consequences of moving to Canada. Our analysis assumes the individual is not a U.S. citizen or green card holder. We recommend that professional advice be sought before the move as many of the tax reduction strategies require action be taken prior to this date.

Generally speaking, an individual entering Canada must pay Canadian tax on worldwide income from the date Canadian residency is established. Prior to this date, Canada only taxes certain types of income (usually income that is Canadian source).

In most cases an individual is considered a Canadian resident as of the date they leave the U.S. and establish a home in Canada. This date usually coincides with the date the individual ceased to be a U.S. resident. Unfortunately, there are many variations and exceptions to this general rule and as such each case is unique.

A few of the more common issues that we encounter when dealing with immigrants to Canada are as follows:

Deemed Acquisition:

Canada deems an individual who establishes Canadian residency to have disposed of, and immediately reacquired, at fair market value each asset owned at the time of arrival. This means that the cost base for determining future taxable capital gains in Canada will be the fair market value as of the entry date and not the original purchase price. As discussed in the November 2001 edition, this “bump” in cost can eliminate Canadian and U.S. tax on gains accrued to the departure date from the United States.

Like most tax legislation that appears simple at first glance, there are multitudes of exceptions to the general rule. There is no deemed acquisition/disposition for Canadian real property and shares of Canadian private corporations. Other exceptions to the general rule include RRSP’s, U.S. Individual Retirement Accounts, employee stock option benefits, and interests in life insurance policies.

Returning Residents:

In a previous edition of *The U.S.TAXFAX* we discussed the deemed disposition on departure provisions. These rules deem an individual who ceases to be a Canadian resident to have disposed of at fair market value all assets held on the departure date (exceptions to this rule include Canadian real estate). The net result is that Canadian tax is often owed on unrealized gains.

Recently enacted legislation enables returning residents to unwind the deemed disposition on departure by filing an election with the Canadian tax return for the year in which they reestablish Canadian residency. Making this election reduces the gain on the departure return by the elected amount. The asset’s cost basis for purposes of calculating future capital gains in Canada is also reduced therefore ensuring future capital gains will be increased by the

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same amount the deemed departure gain was reduced.

Stock Options:

As mentioned previously, stock options are not subject to the deemed disposition/acquisition rules. Canada's position is that 100% of any stock option benefit (i.e. the difference between the fair market value on the date of exercise and exercise price) is taxable in Canada if the option is exercised while a Canadian resident. The U.S. also retains the right to tax any portion of the stock option benefit they consider to have been earned while a U.S. resident. As CCRA and the IRS have differing opinions on how to source stock option benefits, the tax consequences of exercising options granted while a U.S. resident can be unpredictable. We recommend that the U.S. and Canadian tax consequences be carefully considered before exercising these types of options while resident in Canada.

Individual Retirement Accounts (IRA's):

Many individuals moving to Canada have contributed to IRA's while a U.S. resident. IRA's are the U.S. equivalent to the Canadian RRSP. Canadian residents are not taxable on the annual income earned within an IRA account that was funded while a U.S. resident. Withdrawals from an IRA are taxable in Canada to the extent that the withdrawal is taxable in the United States. This non taxable component usually relates to non deductible contributions made in prior years.

401(k) Plans:

401(k) plans are employer sponsored pension plans. In most cases employees elect to make contributions to the plan and the employer matches these contributions to a set maximum percentage of salary.

Amounts received from these plans by a Canadian resident individual are partially taxable. The non taxable component is the amount of distribution considered a return of the employee's original contribution.

Non Resident Trust:

An immigrant with substantial investment assets and income should consider creating an irrevocable non-resident trust before establishing Canadian residency. If the trust meets certain prescribed requirements, it is possible to shelter investment income from Canadian tax for the first 60 months of the immigrant's residency in Canada. As the costs associated with creating and complying with these types of trusts can be substantial, they often only make economical sense for those immigrants with substantial investment income. For those moving from the U.S, we normally recommend that the trust be created in a low tax jurisdiction outside of the United States.

Moving Expenses:

Moving expenses incurred while moving from the U.S. to Canada are not deductible on the Canadian return.

Timing of Employment Income:

Canada taxes employment income upon receipt. As Canadian tax rates are often higher than U.S. rates, we normally recommend that employment income earned outside of Canada be received prior to becoming a Canadian resident. It should be noted that there are exceptions to this general rule.

Recent Developments:

Canada now requires non-resident corporations that claim exemption from Canadian tax under the provisions of a tax treaty to file a prescribed form. CCRA has recently imposed penalties for failure to file these treaty disclosure forms on time. We recommend that careful attention be given to filing these forms by the prescribed due date.

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.