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Tax Tsunami for Non-U.S. Tax Compliant Canadian Residents who are U.S. Citizens or Green Card Holders

By: Jack Bernstein,[1] Aird & Berlis LLP

There are many dual Canada/U.S. citizens or Canadian citizens who hold U.S. green cards (and are not currently working in the United States) who have not filed U.S. tax returns. They are typically paying tax in Canada on their worldwide income. The reason for non-filing in the United States may be innocent, for example, a person was born in Canada and only lived and worked in Canada, but because of U.S. parents is also a U.S. citizen; a person may have been born in the United States but the parents moved to Canada when the child was young and the individual is a dual citizen who never worked in the United States; or a person may have been born in the United States and came to Canada for university and then stayed.

For green card holders, the green card may have been issued a long time ago because of a lottery for green cards (and the person didn't move to the United States), or for a specific business or job the person had which has long since ended. The person now lives and works only in Canada. A green card holder who has had a green card for at least 8 of the last 15 years will be subject to the expatriation rules. Claiming Canadian tax residency under the tie-breaker clause under the Canada–U.S. Treaty would constitute abandonment of the green card. If it happened more than eight years ago, it is possible that the expatriation rules won't apply.

The *Foreign Account Tax Compliance Rules* ("FACTA") may force these individuals to become compliant in 2013. While the regulations aren't out, Canadian and other foreign banks may have to inquire as to the place of birth of individuals who have bank account balances in excess of $50,000. This would go beyond disclosing Canadian citizenship.

One alternative is to review the costs of becoming compliant and to then consider renouncing U.S. citizenship (expatriating).

The United States has a voluntary disclosure program as well as a special program for foreign investments that will expire this summer. The voluntary program requires that U.S. returns be filed from 2003 to present. Penalties under the normal voluntary disclosure program can be up to 75% of the taxes. Entering the program merely protects against criminal prosecution and doesn't reduce taxes and interest. In expatriating (below), some taxpayers have done a silent disclosure and merely filed five years of prior tax returns, taking the risk that additional penalties won't be levied.

In determining the exposure to U.S. taxes, consideration must be given not only to U.S. income tax but also to penalties for not reporting, including:

- Foreign Bank Account Report ("FBAR") – the penalty for wilful non-reporting is forfeiture of 50% of the account balance computed annually.
- Specified Foreign Financial Assets having an aggregate value over $50,000. This is a minimum penalty of $10,000 for non-reporting. There is an additional penalty of 40% of undisclosed or undervalued foreign assets.
- Passive Foreign Investment Company ("PFIC") rules which require taxation of undistributed passive income and gains in foreign (non-U.S.) companies not controlled by a U.S. shareholder. Disclosure is now required of PFICs whether or not distributions have been made.
- Controlled Foreign Compensation ("CFC") rules which require paying tax on subpart F (passive income).
- A requirement to report property transferred to a non-U.S. trust and to report distributions from a non-U.S. trust. There is a 35% penalty for failure to report.
- U.S. gift tax may have applied to prior gifts to a non-U.S. citizen spouse (gifts in excess of $134,000 a year) or to a child (gifts in excess of $13,000 a year). Reporting is also required for gifts of $100,000 or more received from non-residents.

Income will be calculated under U.S. rules when Form 1040 tax returns are prepared. Generally, this will result in the U.S. citizen resident in Canada paying tax on the higher of the Canadian and U.S. tax rates on all sources of income. There are differences in the deductions and exemptions which may be claimed in both countries. For example, a U.S. citizen resident in Canada may deduct a contribution to a Registered Retirement Savings Plan ("RRSP") benefit from a $750,000 capital gains exemption on a sale of shares of a small business corporation and not pay any tax on the sale of a principal residence. The rules are different in the United States – no deduction would be permitted for the RRSP, deduction and the gains on the sale of shares of a small business corporation, or the gain over $250,000 on a sale of a house, will be taxable in the United States.

In addition to filing U.S. tax returns and information returns (e.g., FBAR), a U.S. citizen or green card holder (long-term resident) expatriating (renouncing citizenship or abandoning the green card) will generally be deemed to dispose of all property at fair market value the day before ceasing to be taxable as a U.S. citizen or green card holder. Gains in excess of $600,000 will be taxable. An election is available to defer tax on the property held at the time of expatriation. Interests in foreign non-grantor trusts, retirement benefits, and deferred compensation are exempt from the expatriation tax, but are generally taxable in the United States when distributions are subsequently made.

There are some important exceptions to the market-to-market deemed realization (the exit tax) on expatriation. The rules do not apply if a person is not a "covered expatriate". A person will not be a covered expatriate if the person was at birth a dual Canadian and U.S. citizen, or at the time of expatriation was a Canadian citizen taxed as a resident of Canada, and either (1) he or she was not a U.S. resident for more than 10 years during the period of 15 consecutive tax years ending with the year containing the expatriation date, or (2) he or she relinquished U.S. citizenship before reaching age 18½ and has not been a U.S. resident for more than 10 taxable years of his or her lifetime.

The other exemption is for individuals who meet two criteria: (1) the individual's average annual net income tax was $124,000 or less (adjusted for inflation – $139,000 in 2008) for the five taxable years preceding the year containing his or her expatriation date, and (2) his or her net worth is less than US$2 million on that date.

To avoid being a covered expatriate the individual must certify compliance with U.S. tax laws for the prior five years. Proof may be required that U.S. 1040 tax returns and foreign reporting forms were filed for the five prior years.

A covered expatriate (an individual who doesn't meet the exemptions above) is liable for the exit tax, subject to the $600,000 exclusion. The tax will apply to any gain on a principal residence. The tax applies to any assets of a foreign trust if the expatriating individual is treated as an owner under the grantor trust rules. Form 8854 must be signed and attached to Form 1040 or 1040NR. An election is available to defer tax on a deemed sale of a property. Interest will be charged on the deferred tax. Tax is deferred until the asset is sold or the individual dies. Adequate security must be provided (including letters of credit). The individual would also give up any treaty rights which would otherwise exempt the gain from U.S. taxation.

If subject to the exit tax, the individual for U.S. tax purposes will have increased the tax cost of the asset to fair market value. Double tax results unless the tax cost of the issue is also increased for Canadian tax purposes. A tax election may be available under Article XIII(7) to deem assets to be disposed of for Canadian tax purposes as well. The tax rate in Canada on capital gains is approximately 23% (a credit would be available for the U.S. tax). There would be no taxable capital gain in Canada on a principal residence. The alternative is to elect to defer the exit tax in the United States until a sale of the asset and to post security.

In addition to the exit tax, a U.S. citizen or resident who subsequently receives a gift or bequest from a covered expatriate in excess of the normal gift tax exclusion, or a bequest not otherwise subject to U.S. estate tax, will have to pay U.S. gift tax or estate tax on the gift or bequest.

The mechanics of renouncing U.S. citizenship involve a personal appearance at a U.S. consulate and signing an oath of renunciation (Form DS-4080 – *Oath/Affirmation of Renunciation of Nationality of United States*). The renunciation must take place outside of the United States. A *Certificate of Loss of Nationality of the United States* (Form DS-4083) will be issued and must be retained by the former U.S. citizen.

A green card holder must surrender the green card to U.S. authorities. Physically destroying the green card is not effective. This may require an interview with a U.S. consulate outside of the United States or with Homeland Security in the United States. A person giving up a green card will have to file a sworn written statement with the IRS justifying the termination of tax residency in the United States and establishing that the individual has a tax home in and a closer connection to Canada. Evidence of giving up the green card will also be required.

Notes:

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Personal Trusts and Cottage Properties Residence – Pitfalls and Planning

By: Jack Bernstein and Marni Pernica, Aird & Berlis LLP

A personal trust may own a residence and claim the principal residence exemption on a sale of the property to eliminate or to reduce the gain of the trust. Discretionary personal trusts are frequently used to own cottage properties. The trust may complete and file a Form T1079 *Designation of a Property as a Principal Residence by a Personal Trust.* The trust must specify in its designation each individual who was beneficially interested in the trust and ordinarily inhabited the housing unit (the "specified beneficiary"). The exemption is not available if a corporation (other than a registered charity) or partnership was a beneficiary of the trust. For each year in which the trust designates the property as a principal residence, no other property may have been designated as a principal residence for the calendar year ending in the year by any specified beneficiary of the trust for the year, or by any person who throughout the calendar year ending the year was a member of such beneficiary's family unit (spouse and minor children). In addition, the property is deemed to be designated for the calendar year as the principal residence of each specified beneficiary of the trust. This would apply to each beneficiary of the trust who used the residence. In the case of a family trust owning a family cottage, this could include all beneficiaries.

For example, assume a cottage was acquired in 2000 and has all of the children of the settlor as discretionary beneficiaries. There are three children who were 18 or over in 2000. One child has never owned a house and the other two own their own homes. The cottage is being sold. A designation by the trust would impair the ability by the two children owning a home from designating their own homes as principal residences for the years that the trust owned the cottage being sold. The gain otherwise determined is reduced in accordance with the following fraction:

$$\frac{1 + \text{years designated as a principal residence}}{\text{years owned}}$$

The designation by the trust affects the numerator of every specified beneficiary.

The solution may be to rollout the property to one Canadian resident beneficiary prior to the sale. Subsection 107(2) of the *Income Tax Act* permits a property to be transferred on a tax-deferred basis to a Canadian resident beneficiary. Only that beneficiary would claim the principal residence exemption.

A taxpayer may claim a principal residence exemption subsequent to a subsection 107(2) rollover for the entire period of time he was living in the home despite the fact that the property was held by a trust during the period over which he is claiming the exemption. Under these circumstances the taxpayer is able to claim the principal residence exemption for the entire time he lived in the home. Occasional use of the cottage property would be sufficient.

Pursuant to subsection 40(7), where a beneficiary has acquired a property from a personal trust in satisfaction of all or any part of the beneficiary's capital interest in the trust, and subsection 107(2) applies and subsection 107(4) does not, for the purposes of claiming the principal residence exemption the beneficiary is deemed to have owned the property since the trust last acquired it.

The following example, illustrating the effect of the deemed ownership provision found in subsection 40(7) in conjunction with a subsection 107(2) rollover, is found in Interpretation Bulletin IT-120R6:

> A personal trust acquired a residential property on October 1, 1997 for $75,000. On January 10, 1999, the property was distributed to Mr. X in satisfaction of his capital interest in the trust. Subsection 107(4) did not apply with respect to this distribution, and the rollover provision in subsection 107(2) prevented the gain on the property accrued to January 10, 1999 from being taxed in the hands of the trust. Instead, the potential for taxing that gain was transferred to Mr. X because subsection 107(2) deemed him to have acquired the property