U.S. Tax Ties – Not Beware, Rather Be Aware

Part 1 – Canadian resident clients who do not otherwise have U.S. tax ties

Over the past few years, how many Canadian wealth advisors have been asked by their clients:

> *Did you know we bought a condo in Florida, or a house in Arizona, and are going to be spending the winter months there? Or…*
>
> *What is this form 8840 "Closer Connection Exception Statement for Aliens" that all our snowbird friends are talking about?*

As advisors, we need to be aware of tax legislation that may impact our Canadian clients owning U.S. situs (in situ is Latin for "on site") assets and those clients who spend a significant amount of time south of the border. In addition, we have to be conscious of what compliance issues may arise if clients are vacationing or are snowbirds spending the winter months in the U.S. and want us to enact a transaction in one of their investment accounts.

A) Tax – how can our Canadian clients be exposed to U.S. income and transfer taxes?

In brief, if Canadian clients own U.S. situs assets such as:

- Real and tangible personal property (real estate)
- U.S. securities (a share of Apple, which is traded on Nasdaq, a U.S. stock exchange)
- Certain U.S. debt obligations
- U.S. mutual funds, including money market funds, which are traded on a U.S. stock exchange
- Business-related assets owned by a sole proprietor or a partner (real estate partnership),

they may be subject to the U.S. income tax regime and the U.S. transfer tax regime, which covers off gift and estate taxes.

If a client sells a condo in Florida or collects rent from the house they owned in Arizona, they must report the net income and file a 1040 NR "U.S. Nonresident Alien Income Tax Return"(http://www.irs.gov/pub/irs-pdf/f1040nr.pdf). In addition, as they are a Canadian resident, they must report worldwide income on their Canadian T1 General "Income Tax and Benefit Return" (T1), including the capital gain or loss on the sale of the Florida condo and the net rental income from the Arizona house converted to Canadian dollars, as well as any taxes paid to the IRS or taken as foreign tax withholdings for Canadian foreign tax credit purposes.

Canadian clients may also be subject to the U.S. transfer tax regime. If a Canadian client simply adds the name of their spouse to their condo in Florida or sells the Arizona condo for less than FMV to their children, U.S. gift tax may be triggered. If a Canadian client passes away owning a U.S. situs asset, for example a condo in Florida or shares of Apple in their open account, RRSP/RRIF, or TFSA, they may have to file a U.S. estate tax return and also be subject to U.S. estate tax. U.S. estate tax is not based upon income or a capital gain being realized upon death, rather it is a tax based upon ownership of a U.S. situs asset and the FMV at the time of the Canadian client's death.

Form 706NA "United States Estate (and Generation-Skipping) Tax Return, Estate of a nonresident not a citizen of the United States" (http://www.irs.gov/uac/Form-706-NA,-United-States-Estate-(and-Generation-Skipping-Transfer)-Tax-Return) must be completed if the FMV of the U.S. situs assets exceeds US$60,000 at the time of Canadian client's death. A U.S. estate tax liability may be triggered if a Canadian client's worldwide wealth is in excess of US$5.49 million (2017) – consider the value of their principal residence, shares of a business or farm land, ownership of life insurance, open and registered assets collectively – if they own US$1 of U.S. situs assets.

Tax – how can our Canadian clients avoid being considered a U.S. taxpayer?

It all comes down to whether your client meets the Substantial Presence Test. A Canadian is considered a U.S. resident alien (thus a U.S. taxpayer) if they are physically present in the U.S. for at least:

- 183 Days or more in the current year; or
- 31 days during the current year; and
- 183 weighted days during the current and previous two years. The weighted day calculation is:

  1 * current year days + 1/3 * previous year days + 1/6 second previous year days.

Most clients are aware that if they spend in excess of 183 cumulative days in the U.S. in a given calendar year they will be considered a U.S. taxpayer; however, some may not be aware of the second 183 weighted day calculation.

In brief, if you have Canadian clients who are snowbirds and they are in the U.S. on average more than four months (123 days cumulative per year) annually, they are considered U.S. resident aliens unless they demonstrate a closer connection with a different tax jurisdiction – for example, Canada. Canadian clients have to demonstrate the closer connection by filing Form 8840 "Closer Connection Exception Statement for Aliens" annually. The form and instructions on how to complete the form can be found at http://www.irs.gov/pub/irs-pdf/f8840.pdf.

How will the IRS or CRA know about how many days a client has spent in the U.S.? In June 2014, the final phases of the Perimeter Security and Economic Competitiveness Plan were implemented. Canada and the U.S. are now sharing, in real time, information concerning individuals visiting Canada and the U.S.

B) Compliance – what do I have to be aware of when I know a Canadian client is physically in the U.S. and requests a transaction?

When you are aware an existing client is moving to the U.S. or is physically in the U.S. when requesting a transaction, you should reach out to your compliance department to determine what your or your dealership's current registration permits in the circumstances. In other words, do you have the appropriate registration through the U.S. Securities and Exchange Commission (SEC) to enact the transaction or continue working with the client once they have moved to the U.S.?

Commonly suggested tools such as "trading authorizations" or a limited power of attorney over investment accounts can be put in place for snowbird clients covering the duration they are physically in the U.S. and should be discussed with your compliance department.

As always, it is recommended that if a client has or may have U.S. tax ties, they should consult a competent cross-border tax advisor.

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