ANDERSEN TAX

# Top 5 Tax Issues: Canadians Moving to the U.S.

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**This article considers the top 5 tax issues for individuals moving from Canada to the United States. Doing so may create significant tax opportunities and issues. The commentary is intended to highlight some relevant issues and does not constitute tax advice. Please contact Andersen Tax LLP to discuss your facts and circumstances.**

## Topics:



## 1. Tax Residency

### The issue?

The country in which you are a tax resident gets to tax you on your worldwide income.

### Why does it matter?

Your tax residency is different than your immigration status, residency for health care and other purposes.

Canada uses a subjective measure of tax residency and the U.S. uses an objective measure. It is not unusual for individuals to be tax residents of both countries under their respective tax laws. The Canada-U.S. Income Tax Convention (Treaty) provides a tie-breaker test in those situations. Savvy taxpayers should seek to arrange their facts in the manner that gets them the best tax result.

***Scenario 1: Moving to the U.S. prior to July 2nd***

An individual who is physically present in the U.S. for more than 182 days in a calendar year will be a U.S. tax resident in that year. They can also be a U.S. tax resident where they have status as a lawful permanent resident of the U.S. (Green Card holder). If an individual is not a tax resident of the U.S., they will continue to be a tax resident of Canada.

***Scenario 2: Snowbirds***

Individuals who spend part of the year in the U.S. will be U.S. tax residents where they spend more than 31 days in the U.S. in the current year and the sum of their U.S. days in the current year, a third of their U.S. days in the preceding year and a sixth of their U.S. days in the second preceding year exceeds 182 days.

***Scenario 3: Individuals on Temporary Assignment to the U.S.***

Individuals on temporary assignment to the U.S. may cease to be tax residents of Canada even where their spouse and dependents continue to reside in Canada. Such individuals would only be subject to U.S. tax on their worldwide income where they are U.S. tax residents under U.S. tax law and the Treaty tie-breaker test.

***Scenario 4: Moving from Canada to the U.S. after July 1st***

Individuals present in the U.S. for less than 183 days in the year without a Green Card will not be tax residents of the U.S. unless they are eligible to make a “first-year election”.

### What’s the solution?

Solutions will depend on the facts and circumstances, but may include:

- Identifying the assets that you intend to retain while resident in the US and what their impact is on your tax picture. Canadians moving to the U.S. are not required to sever all connections with Canada to cease Canadian tax residency.
- If any residential connections to Canada are to be retained, apply the Treaty tie-breaker test to determine your tax residency to assess the likely result in advance.

- Evaluating the tax implications of ceasing Canadian tax residency and becoming a U.S. tax resident, assess how their facts would determine their tax residency status and modify them in advance to provide additional certainty.
- Snowbirds can avoid U.S. tax residency where their days in the year in the U.S. are less than 183, have a closer connection to Canada and ensure timely-filing of IRS Form 8840.
- To establish US tax residency for moves after July 2nd, the taxpayer may be eligible to make the "first-year election". It requires presence in the U.S. for 31 consecutive days in that year and meet certain other requirements in that year and the following year.

## 2. Canadian Departure Tax

**The issue?**

Tax residents of Canada are subject to Canadian capital gains tax as if they disposed of their worldwide capital assets when they cease to be tax residents of Canada.

**Why does it matter?**

Canada's departure tax applies on the unrealized appreciation of some, but not all, of your worldwide assets even though you didn't receive any monies to pay the tax.

***Scenario 1: Taxpayer Owns Shares of Corporations***

Canada's departure tax applies to shares of all corporations. Foreign exchange gains and losses may arise from both equity and debt securities.

***Scenario 2: Stock Options, Pension, and Registered Accounts***

Canada's departure tax does not apply to stock options, pensions and registered accounts in Canada.

***Scenario 3: Taxpayer Owns Real Property in the U.S.***

Canadian real property owned by departing tax residents of Canada is not subject to its departure tax, but real property in other countries is taxable.

**What is the solution?**

Canada's departure tax appears to be a significant impediment to Canadians leaving the country. The good news is there are solutions:

- Departure tax may be deferred interest-free in a timely-filed Canadian tax return for the applicable year if the required security can be provided to CRA;
- Generally, CRA will accept the assets that give rise to the departure tax as security;
- Canada's departure tax can be deferred until the earlier of the date you dispose of the assets or your death;
- You can elect to increase your U.S. tax cost on the assets subject to Canada's departure tax to their fair market value at the date you depart Canada to avoid U.S. tax on pre-U.S. tax residency appreciation when you dispose of the assets.

## 3. Minimizing Tax with Foreign Tax Credits

**The issue?**

Generally, Canada has higher income taxes than in the United States.

**Why does it matter?**

It may be possible to recover some or all the Canadian tax payable in the year you cease to be a tax resident of Canada. This amount could be worth thousands of dollars.

The U.S.'s foreign tax credit regime allows non-U.S. income tax payable to offset U.S. tax on qualifying income earned outside the U.S. for up to 10 years in the future.

***Scenario 1: Travels outside the U.S.***

If you travel outside the U.S. and provide substantive employment services (emails, teleconferences, etc.), the income earned is foreign source income for U.S. tax purposes. The related U.S. tax may be offset with foreign tax credits from tax paid to Canada and other countries on employment or business income for both the year earned and the year of departure.

***Scenario 2: Non-U.S. Investment Income***

U.S. tax on investment income earned from outside the U.S., including dividends, interest, rents, and royalties may be offset by non-U.S. income taxes paid on such income in the year earned.

**What is the solution?**

When an individual departs from Canada, it is generally desirable to depart earlier in the year to minimize the amount of Canadian income tax payable, generally at higher tax rates. That solution is not always available due to business and personal concerns:

- You can establish U.S. tax residency under U.S. tax law earlier in the year even where Canada and the Treaty might still treat you as a tax resident of Canada. Doing so allows you to claim Canadian tax paid or accrued during that period which can be carried over for up to 10 years.

- If you are married and you or your spouse are a tax resident of the U.S. by the end of the year, you may elect to be taxed as U.S. tax residents under U.S. tax law for the entire year.
- Canada's departure tax may be claimed as a foreign tax credit but it must be paid within two years of the year it accrued to be claimable as a foreign tax credit.

## 4. CPP vs. U.S. Social Security

**The issue?**

Employees in the U.S. and Canada must be covered under their respective social security programs, U.S. Social Security and Medicare Tax (FICA) and Canada Pension Plan (CPP).

**Why does it matter?**

U.S. Social Security benefits are substantially higher than CPP, but its cost is even higher. For an employee earning US$100,000 their FICA would be US$7,650. The CPP on that individual would be C$2,900, roughly an annual difference of US$5,500 from FICA (2020). If you are also the employer, you need to match the employee's tax, making it an US$11,000 annual difference before claiming the tax deduction.

On US$500,000 of earnings FICA would be US$20,287 vs. C$2,900 in Canada (2020), a difference of roughly US$18,100 annually in favour of CPP.

***Scenario 1: Executive Transferred to U.S. by Employer***

Employees transferred by their Canadian employer to their U.S. affiliate may qualify for coverage under CPP for up to five years.

***Scenario 2: Canadian Employer Moving to the U.S.***

Where you are the employer and you are moving to the U.S. with some or all your operations, you can be eligible to continue your coverage under CPP.

***Scenario 3: Self-Employed Canadians Moving to the U.S.***

If you are self-employed in Canada, you are not eligible for coverage under CPP, but if you incorporate your employment services prior to departing for the U.S. you would be eligible for CPP coverage.

**What is the solution?**

Employment transfers to the U.S. are required to continue their coverage under CPP. Unless you have an employment agreement that exceeds five years, you will likely qualify to stay on CPP.

On US$100,000 of earnings your after-tax savings over five years would be approximately US$27,500 and US$90,500 at US$500,000 of earnings.

This solution is advantageous to you and your employers. After five years you will be required to pay FICA from that point forward with limited exceptions.

Generally, if you pay into FICA, you will be eligible for benefits based on your period of work in the U.S. and Canada provided it exceeds 10 years (40 quarters). Your U.S. Social Security benefit will be based on your FICA contributions only. Medicare eligibility only applies if you are subject to FICA for 10 years (40 quarters).

## 5. Investments in Canadian Corporations

**The issue?**

Ownership of corporations formed outside the U.S.

**Why does it matter?**

U.S. tax law is concerned that income earned in corporations formed outside the U.S. defers or avoids U.S. tax. Its rules may attribute undistributed income earned corporately to U.S. shareholders or subject them to adverse tax results.

***Scenario 1: Shares in a Closely-Held Canadian Corporation***

A corporation formed outside the U.S. that U.S. persons directly or indirectly own more than 50% of the voting shares will be treated as a Controlled Foreign Corporation ("CFC"). CFC net income may be attributed to certain U.S. shareholders. The attribution of this income may result in tax in the U.S. now without offsetting tax credits when Canada taxes it on distribution.

You may be required to make the required U.S. tax disclosures, even where your interest in the non-US corporation is 50% or less because of shares attributed to you from family members.

***Scenario 2: Investments in Canadian Mutual Funds***

Generally, all mutual funds, exchanged-traded funds (ETFs) and similar investment vehicles formed outside the U.S. will be treated as Passive Foreign Investment Companies ("PFICs") for U.S. tax purposes, even where they are formed as trusts under Canadian law or invest in U.S. entities. Operating companies may also qualify as PFICs.

U.S. shareholders of PFICs are taxable when they receive distributions or realize a gain on disposition. Their proceeds are taxable federally in the U.S. at the top marginal tax rate (39.6%) over the holding period vs 20% for qualifying dividends and gains. U.S. shareholders of PFICs are charged interest on their notionally deferred income and face restrictions on foreign tax credits and loss carry-forwards.

### What is the solution?

Investment in entities formed outside the U.S. has a high degree of complexity with respect to both CFCs and PFICs. Some solutions may include:

- Avoiding CFC status by using a hybrid entity.
- Distribute the Canadian corporation's tainted assets and minimize Canadian corporation's taxable income to avoid income attribution.
- Minimize the Canadian corporation's taxable income to avoid attribution.
- Making an election to allow you to claim the Canadian corporate income tax as a foreign tax credit to offset your U.S. tax otherwise payable.
- Disposing of PFICs prior to U.S. tax residency.
- Investing only in PFICs that allow you to make a Qualified Electing Fund election.
- Electing under the Mark-to-Market tax regime.
- Reviewing acquisition of future investments outside the U.S. in advance.

## Further information

If you want more information on any of the above issues or others, please contact any the following:


**Warren Dueck, Partner**
**T:** 604-242-1401 or 587-390-1610
**E:** warren.dueck@AndersenTax.ca

**Steven Flynn, Partner**
**T:** 604-242-1416
**E:** steven.flynn@AndersenTax.ca

**Jonathan Garbutt, Principal**
**T:** 587-390-6569
**E:** jonathan.garbutt@AndersenTax.ca

**Krista Rabidoux, Principal**
**T:** 587-390-6568
**E:** krista.rabidoux@AndersenTax.ca

**Eric Trumbull, Principal**
**T:** 604-242-1406
**E:** eric.trumbull@AndersenTax.ca

**Emily Yu, Principal**
**T:** 604-242-1405
**E:** emily.yu@AndersenTax.ca

**Catherine Shen-Weafer, Senior Manager**
**T:** 604-242-1407
**E:** catherine.shen-weafer@AndersenTax.ca

**Darren Bastarache, Senior Manager**
**T:** 587-390-1616
**E:** darren.bastarache@AndersenTax.ca


## Other "Top 5" Subjects

- Americans Moving to Canada
- Canadians Doing Business in the U.S.
- Canadian Investment in U.S. Rental Property
- Canadians Buying U.S. Vacation Property
- Americans Doing Business in Canada
- Americans Investing in Canadian Real Property
- Americans Buying Canadian Vacation Property
- U.S. Estate and Gift Tax for Canadians