US tax changes

Kim G C Moody FCPA, FCA, TEP
July 22, 2008

As most readers know, Canada's system of taxation is one that will tax based upon residency. To the extent that you are a resident of Canada, you will generally pay Canadian income tax on your worldwide sources of income. To the extent that you are a non-resident of Canada, only certain types of income (such as Canadian source income or dispositions of taxable Canadian property) will be subject to Canadian income tax. Most of the countries in the world have a similar system of taxation as that in Canada where the primary tax basis is that of residency.

To the extent that a Canadian resident dies, the Canadian resident will be deemed to have disposed of their non-registered assets at fair market value. Any registered assets are generally deemed to be received as income upon death. There are limited deferrals available for such deemed dispositions or income inclusions. One of the most common deferrals upon death is that of ensuring that the assets vest indefeasibly with the surviving spouse or common-law partner.

A similar deemed disposition (the so called "exit tax") occurs when a Canadian resident becomes a non-resident of Canada. For example, if a resident of Canada permanently moves away from Canada and cuts all residential ties with Canada then the former resident is deemed to have disposed of all of his assets at fair market value (with certain exceptions like RRSP's and others) immediately prior to becoming a non-resident pursuant to subsection 128.1(4) of the Act. Accordingly, great caution and planning must occur before a resident of Canada decides to become a non-resident of Canada in order to minimize income tax exposure. The CRA's views on residency are outlined in Interpretation Bulletin IT221R3 – *Determination of an Individual's Residence Status*.

The United States has a completely different taxation system. It is one of the few countries in the world that imposes its tax system based upon citizenship. Generally, if you're a US citizen (or considered to be a US resident for tax purposes by virtue, for example, of holding a US "Green Card") then such a US citizen will be taxed on their worldwide income irrespective of where they are domicile. Certain exemptions and foreign tax credits are available to reduce or eliminate US tax. However, a US citizen is still required to comply and file a US income tax return annually on their worldwide income. The US also has an extensive transfer tax regime whereby it will tax its citizens upon death (the estate tax) subject to certain deferrals and exemptions being available. Such exposure to the estate tax can be rather nasty given that it is a tax based on the fair market value of the citizen's worldwide estate and not a tax on appreciated value.

The US system of taxation catches many Canadian residents by surprise to the extent that they are also a US citizen. Our practice frequently encounters persons who are US citizens (and also Canadian residents) who are not filing their US income tax returns on an annual basis. Such a person is often also not aware of the US estate tax exposure that they may have and therefore they will often look for alternatives to try and minimize both exposure to US income tax and US estate tax. Without a doubt, one of the topics that comes up during conversation at such meetings with the US citizen/Canadian resident, who is unaware of their exposure, is whether or not they could renounce their US citizenship as a means to escape the overall US income and transfer tax regime.

Our common answer to such a topic is that renunciation is a very personal matter. Great caution should be taken before renouncing US citizenship. Such a decision involves reflection of personal goals and objectives, the impact of current and future immigration, tax, gift and estate law matters. It is our experience that once a US citizen understands the overall implications of renouncing US citizenship, it is often not pursued.

For over 40 years, the US has had provisions to tax and thereby discourage US citizens from giving up their US citizenship for tax avoidance reasons. However, for many years they were not enforced. A number of legislative changes have occurred over the last few years, with the first occurring in 1996 followed by changes in 2004 and an additional change as recently as June of this year as discussed more below.

Under the changes of 1996, the presumption by the IRS was that US citizens were primarily renouncing their citizenship for tax-motivated reasons. This presumption was removed with the changes brought about in October 2004. In 2004, The Alternative Tax Regime was introduced whereby certain US citizens and long term residents (persons who had held a Green Card for greater than 8 out of 15 years) were subject to the requirement to file US income tax returns for 10 years following the date of expatriation on US source income. Further, these individuals were also required to provide the disclosure of very specific financial and income information for the next 10 years. Lastly, if an expatriator was in the US for greater than 30 days in a calendar year over the next 10 years, they would then fall under the current US income, gift and estate tax regime in that year.

As part of a review of the US expatriation tax, the US has long debated whether or not they should introduce an exit tax similar to that of Canada (as discussed earlier). Well, the US exit tax has arrived. It now applies to any US person (defined to be a "covered expatriate") who has expatriated after June 16, 2008. The new rules apply in Internal Revenue Code section 877A that was introduced as part of the *Heroes Earnings Assistance and Relief Act*. A covered expatriate is generally any citizen or long term resident who gives up or loses their US citizenship, has a net worth in excess of US$2M or an average annual income tax liability in excess of US$139,000 (inflation adjusted) for the 5 years preceding expatriation or fails to certify compliance with the Internal Revenue Code for the 5 years preceding expatriation. If such conditions are met, the covered expatriate will now be deemed to have disposed of all of their assets (with certain exceptions) at the date of expatriation at fair market value. The first US$600,000 of deemed disposition income is exempt from US tax. Additionally, any direct or indirect gifts made by a covered expatriate to a US person would be subject to tax at the highest rate in the US (currently 45%). This tax would be paid by the recipient (US person), not the covered expatriate!

The new proposals in Internal Revenue Code section 877A are quite complex. Accordingly, the Canadian resident/US citizen who wishes to renounce their US citizenship will now have another hurdle to consider when dealing with their tax and estate planning affairs. The above general explanation is by no means complete and is only intended to identify the introduction of a new US exit tax. Readers who desire more information should contact our firm. We would be pleased to put you in touch with our US tax colleagues who are experts in such areas.