Twelve Canada-US tax tips for 2016

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By now the 2015 holiday season is a distant memory, as are most of those well-meaning 2016 resolutions. For those individuals with both Canada and US tax issues, tax filing season is a few months away; however, there are several steps you can take that will ease your burden in the next few months… or at least ease it next year.

1. **Catch up on** US **tax compliance**

The US generally imposes tax filing and liability obligations on all “United States persons,” regardless of their residence. US persons generally include US citizens, lawful permanent residents (i.e., a green card holder), and individuals who are substantially present in the US. Offshore enforcement is, has been, and will continue to be amongst the highest priority areas for the IRS. Thus, now more than ever, US persons living outside the United States should focus on becoming compliant before receiving a less-than-friendly letter from IRS.

The IRS has established several amnesty programs, under which a previously non-compliant individual (i.e., a US citizen living in Canada who has never filed US tax returns) can become compliant and avoid potentially stiff penalties. However these amnesty programs generally require the taxpayer to come forth before being contacted by the IRS. Under the Foreign Account Tax Compliance Act (“FATCA”), which was brought to Canada through an intergovernmental agreement and Canadian legislation, the CRA recently began forwarding information to the IRS regarding Canadian bank accounts held by US persons.

As a result of the FATCA information transfers, the IRS can easily identify US persons living in Canada and track their US tax compliance status. Noncompliance can bring severe civil penalties or even criminal punishment in some circumstances.

2. **Renounce your US citizenship**

If you are tired of annual US tax compliance and sick of paying extra taxes, you may put US citizenship renunciation on your resolution list this year. Record numbers of US citizens continue to renounce and, as a result, the lines at US consulates to get a renunciation appointment grow. In addition, the certificate of loss of nationality is usually not issued until several months after the renunciation date, which could cause your account to be reported under FATCA if you haven’t received it by June 1, 2016.

3. **Close your TFSA or RESP**

TFSAs and RESPs are generally treated as foreign grantor trusts for US tax purposes. Income from a foreign grantor trust flows through to US taxpayers who are considered its owners. This income is subject to US tax currently, notwithstanding that the income is only taxed to the beneficiaries for Canadian tax. In addition, Forms 3520 and 3520-A must be filed annually to report the trust income,

assets, and distributions. Failure to file either form can result in a penalty of US$10,000. To avoid the compliance complexity associated with Forms 3520 and 3520-A for 2017, US persons can simply close their TFSA or RESP before the end of 2016. If closing the RESP is not an option because of a significant amount of government grant or deferred income, consider transferring title to a non-US person who will not have US tax filing obligations. Note that such a transfer may be treated as a gift subject to its own information reporting requirements and potential gift tax liability.

4. **Surrender signatory authority on financial accounts**

US taxpayers must file FinCen Form114 (known as the FBAR) if the combined maximum balance of all foreign financial accounts exceeds US$10,000 at any time during the year. Taxpayers must take into account any foreign financial account they have a financial interest in or signatory authority over. Even if you are only a trustee of a trust, a treasurer of a charity organization, or a corporate accountant without a financial interest in the account, you could still be subject to FBAR reporting. If possible, relinquish your signatory power over these accounts to reduce your FBAR reporting burden, unless of course, it is required to maintain gainful employment.

5. **Crystallize capital gains**

Relative to the US dollar, the Canadian dollar is at a 20 year low. Typically, a spot exchange rate is used for purposes of converting the cost basis and disposition proceeds before calculating net capital gain or loss. Given the dramatic fluctuation in relative value between the Canadian and US dollars, this calculation can result in significant disparities between US and Canadian tax results (i.e., create a loss for Canadian tax purposes, but a gain for US tax purposes). Currency fluctuation problems can be amplified by mismatched Canadian and US tax rules. For example, only 50% of capital gains are typically taxable in Canada, while the full amount is taxable under US rules. Couple these rules with increased tax rates in Canada (i.e., the highest combined marginal tax rate in Alberta is 48% for 2016, up from 40.25% in 2015), and you are left with a headache for some, but fertile tax planning grounds for others.

6. **Simplify Canadian mutual fund investments**

You may be surprised to be told to prepare Form 8621 with your US return for some mutual funds invested in non-registered accounts, however the IRS's current administrative position (which does not carry the weight of law) is a US tax rule regarding passive foreign investment company ("PFIC"). Consequentially, the conservative approach is to treat Canadian mutual funds held outside of a registered account as PFICs. As a result, you could be subject to a double taxation trap because of significant differences in reporting foreign mutual fund income between two countries.

To avoid filing Form 8621, some useful tax deferral vehicles such as RRSP/RRIF/RPP can be used to hold Canadian mutual funds since they are qualified for tax treaty benefits. Buying U.S. mutual funds through U.S. financial institutions is also a good option, but of course you might need to file T1135 disclosing the foreign investments to the CRA. Alternatively, holding shares directly or limiting the numbers of Canadian mutual funds can help simplify PFIC reporting as well. Again, planning on these by year end can save a lot of compliance costs for you.

7. **Make distributions from corporations, LLCs, and partnerships**

The controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC") rules are a trap for unwary US persons if too much passive income is earned. The detailed rules on CFCs and

PFICs are beyond the scope of this blog, but generally speaking, US persons should be cautious when generating investment income through non-US corporations. Similarly, caution should be exercised when utilizing a US limited liability company (“LLC”) or limited liability limited partnership (“LLLP”) structure, as these entities are potentially subject to different treatment under Canadian and US tax law. LLCs and LLLPs are considered flow-through entities for US tax purposes (meaning there is only one level of tax, not a separate entity level tax). By contrast, LLCs are generally considered corporations for Canadian tax purposes and LLLPs are potentially treated in the manner, and therefore could be subject to two layers of tax (one at the entity level, and one at the shareholder level).

If income generated by an LLC or LLLP is retained at the entity level, the shareholder reports the income on his personal US income tax return, but not on his Canadian tax return, even if there is no corresponding distribution. Thus, a foreign tax credit would be unavailable due to the timing mismatch and different taxpayers (for the US, the taxpayer is the individual shareholder, whereas for Canada, the taxpayer is the LLC or LLLP). Ordinarily S corporations face the same problem, but the US-Canada income tax treaty provides relief under Article XXIX(5), subject to competent authority approval. However, attention needs to be given to the foreign accrual property income (“FAPI”) reporting regime for Canadian tax purposes.

8. **Distributions from a Canadian trust**

Many Canadian trusts are deemed “grantor trusts” for US tax purposes. Under the grantor trust rules, that portion of trust income deemed “owned” by the grantor is included in the grantor’s income, not the trust’s income, for US tax purposes. The grantor trust rules do not apply for Canadian tax purposes, often resulting in a mismatch of income, because the trust itself or its beneficiaries must take that income into account, rather than the grantor. This can result in double taxation, a foreign tax credit mismatch, or both. Moreover, once actual distributions are made to non-grantor beneficiaries, they will likely be deemed gifts made by the grantor subject to US gift tax rules. One would be wise to review the trust deed carefully before making any distributions.

9. **Review US gift tax planning**

US persons are entitled to make annual gifts of US $14,000 in 2016 to an unlimited number of individuals without triggering gift tax return filing obligations or reducing their basic exclusion amount of US$5.45 million. Gifts to a nonresident spouse of up to $148,000 are also excluded from filing obligations and reduction of the unified exclusion amount. Although these exclusions are available annually, they cannot be accumulated or carried over to later years. Furthermore, any taxpayer involved in estate or gift tax planning must pay close attention to Canadian attribution rules.

10. **Reconsider spousal income splitting**

Income-splitting planning previously utilized by Canadian couples will probably be rendered ineffective in 2016. Through 2015, the Liberal government will likely still allow taxpayers to take a credit of up to CA$2,000 for the amount of tax that could be saved as a result of income-splitting. Even if you qualify for the marginal relief provided by the CRA, you may have to pay the saved tax to the IRS if you are a US taxpayer with a higher income than your spouse. Canadian taxes paid by an individual’s spouse cannot be utilized as a credit against that individual’s income tax when filing separately in the US. As a result, any attempted income-splitting including pension split may prove ineffective.

11. **Exercise stock options**

Canadian and US tax laws often differ in the stock option context. In some situations, the US imposes tax when the options are vested rather than exercised. By contrast, Canada generally imposes tax once the options are exercised. In others, tax on certain stock option benefits can be deferred until disposition for Canadian tax purposes, but subject to US tax when exercised. You might be entitled to a 50% deduction for benefits arising from Canadian controlled private corporations for Canadian tax purposes, but are prohibited from doing so on the US side.

These differing rules often result in foreign tax credit mismatches and double taxation. Therefore, consider both the US and Canadian implications of stock options before exercising them.

12. **Manage your time spent in the US**

For a Canadian who is not a dual citizen or green card holder, you can still be treated as a US resident for income tax purpose if you spend significant time south of the border and meet the substantial presence test. Usually, Form 8840, 8833 and 1040NR may be required depending on the actual days you have spent in the US during the past three years. The simple Form 8840 can be filed instead of Form 1040NR and 8833 if you spend less than 183 days during 2015. Going forward, you may want to carefully plan your vacation to avoid the magic number of 183 considering the burdensome US tax compliance. For those of you who would like to start tracking your US days, our firm's app is here to help you.

The above are general issues facing certain Canadians who have US tax exposure. Spending some time with a glass of wine planning for these may save big headaches in the near future.