

TAX BULLETIN

July 2011

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U.S. Tax Issues for Canadians

To ensure compliance with the U.S. Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

If you own rental property in the United States or spend extended periods of time there, you could be subject to various U.S. filing requirements, even though you may have no U.S. tax to pay.

The U.S. government is concerned about non-resident aliens avoiding taxes or taking aggressive filing positions, and about the difficulty of monitoring these developments. In response, U.S. legislators have introduced a number of measures over the years to stop what they perceive as abuse of the system, by tightening deadlines and increasing penalties for failure to comply. With Canadians being among the biggest investors in the U.S., it's not surprising that they should bear much of the administrative burden of these requirements.

This bulletin outlines the rules and the penalties that could apply for not complying with these filing requirements. The comments below are aimed at Canadian residents — that is, individuals who are considered resident in Canada for tax purposes and pay taxes here. We'll refer to them as simply "Canadians". If you're a Canadian citizen living full-time in the U.S., there may be other considerations not covered in this bulletin. Contact your BDO advisor about your personal circumstances. If you are a resident of another country (other than the U.S.), it's likely that many of the comments in this bulletin also apply to you, since they arise from U.S. domestic tax law. Finally, if you're a U.S. citizen or "green card" holder and live in Canada, ask your BDO advisor for a copy of our tax bulletin titled *Tax Consequences for U.S. Persons in Canada* for information on your U.S. tax and filing requirements, as the comments in this bulletin do not apply to you.

Snowbirds

Like the nickname implies, “snowbirds” are Canadians who spend a considerable amount of time in the U.S. (often to escape our winters).

If you are a snowbird, there are a number of U.S. tax issues that you should be aware of because the last thing you want is to find yourself inadvertently liable for U.S. income tax or subject to U.S. penalties for failing to satisfy U.S. filing requirements.

Does the U.S. consider you a U.S. resident?

Despite the fact that you might consider yourself to be resident in Canada (for example, because you pay Canadian income taxes) – if the number of days you spend in the U.S. exceeds certain limits, you may be considered a U.S. resident. The U.S. Internal Revenue Service (IRS) applies a test known as the “substantial presence test” to determine whether an individual who spends part of the year in the U.S. is a resident of the U.S. for U.S. income tax purposes.

Substantial presence test

Under the substantial presence test, you will be considered a U.S. resident by the IRS if:

- the weighted total of the number of days you spent in the U.S. over the last three years (determined using the formula set out below) equals or exceeds 183 days, and
- you have been in the U.S. for more than 30 days in the current year.

The weighting formula that is used in the substantial presence test is as follows:

The number of days in the U.S. this year,
plus
1/3 of the number of days in the U.S. last year,
plus
1/6 of the number of days in the U.S. the year
before last.

Obviously, if you spend 183 days (6 months) in the U.S. in any given year, you will meet the substantial presence test. But, if you regularly spend over 4 months a year in the U.S. (122 days), under the formula you will also be considered a U.S. resident.

Given that the substantial presence test relates to the number of days you are in the U.S. – it is important that you count the days carefully. The IRS normally counts as a full day any day that you are in the U.S., even for just a portion of the day. However, some of the days you are in the U.S. may be excluded from the calculation. For example, you may be able to exclude days when you were in the U.S. if you can show that you intended to leave but were unable to because of a medical condition that developed while in the U.S. Similarly, you may exclude days that you were in transit in the U.S. for less than 24 hours on your way to another foreign country (for example, if you had a layover in Chicago on your way to Mexico). As well, you may be able to exclude days spent as a teacher, trainee, student or professional athlete competing in certain charitable sporting events. In order to exclude days of presence in the U.S. for purposes of the substantial presence test calculation, you will need to file Form 8843 to explain the basis of your claim. Filing deadlines are discussed later in this bulletin.

Consequences of being considered a U.S. resident

If you meet the substantial presence test in any given year, you’re automatically considered a U.S. resident for U.S. tax purposes for that year and are, therefore, subject to U.S. tax and filing requirements. This will be so, even though you may also be a Canadian resident and pay Canadian taxes.

If you are considered a U.S. resident, you can do one of two things:

- 1) you can claim the “closer connection exception” allowed under the Internal Revenue Code (the Code), or
- 2) you can claim a treaty exemption.

Claiming the “closer connection exception”

You can avoid being considered a U.S. resident by claiming that you actually have closer connections with another country (such as Canada). To claim the closer connection exception, you must file Form 8840 with the IRS. On Form 8840, you must indicate the number of days you spent in the U.S. and you must answer questions that demonstrate that you had a closer connection with Canada during the year.

Factors that indicate a closer connection with Canada include:

- having a permanent home in Canada,
- having family in Canada,
- having personal belongings in Canada,
- banking in Canada,
- carrying on business in Canada,
- having a Canadian driver’s licence, and
- voting in Canada.

Although questions about your involvement in social, cultural, religious, political and professional organizations have been removed from the form, these factors are still relevant in establishing a closer connection to Canada.

You cannot claim the closer connection exception if:

- you spent more than 183 days in the U.S. in the current year, or
- you have — or have applied for — a U.S. “green card” (permanent resident status in the U.S.).
- you did not file Form 8840 by the due date

When filing Form 8840 to claim the closer connection exception — unlike most other IRS forms — you do not need a U.S. taxpayer identification number. However, you must sign Form 8840 under penalty of perjury, which means you could be subject to prosecution for reporting false information.

The deadline for filing Form 8840 and the penalties for failure to file are discussed below.

Dual resident individuals (non-U.S. citizens)

If you can't claim the closer connection exception, then you are a dual resident and therefore, considered to be a resident of both Canada and the U.S. under each country's tax laws. In such cases, the Canada-U.S. Tax Treaty has “tie-breaker” rules under which your residence for purposes of income taxation is ultimately determined. Your BDO advisor can assist you in determining your residence under these rules.

Canadian resident under tie-breaker rules

If you tie-break to Canada, in most cases (but not all), the Canada-U.S. Tax Treaty will protect you from having to pay U.S. tax on your income. However, you are still subject to the filing requirements of the Code and the penalties for not adhering to them.

If you are considered resident in the U.S., but you cannot claim the closer connection exception — for example, if you spent more than 183 days in the U.S. in the year or you didn't file Form 8840 on time — you must file a U.S. income tax return (Form 1040NR) for the year in question and also claim a treaty exemption as explained below. In addition, you may also be subject to the U.S. foreign reporting requirements.

On the 1040NR return, you must declare all U.S. source income. For snowbirds, this is usually only interest and dividends, both of which are normally subject to a flat non-resident withholding tax (with interest currently subject to a 0% withholding rate). Any income and taxes withheld are reported on the 1040NR and this return must be signed under penalty of perjury.

Claiming a treaty exemption

To claim a treaty exemption, you must attach a completed Form 8833 to your 1040NR. On Form 8833, you must explain that you are a resident of Canada and are not subject to regular U.S. income tax rates on this U.S. source income under the provisions of the Canada-U.S. Tax Treaty.

Both the 1040NR and Form 8833 require a U.S. taxpayer identification number. For individuals who are not eligible to obtain a Social Security Number (SSN) (i.e. individuals not having U.S. immigration status), this number is known as an "Individual Taxpayer Identification Number" (ITIN). To obtain an ITIN, you must file Form W-7 and proof of identity and foreign status, along with your original completed tax return. After the W-7 has been processed, the IRS will assign an ITIN to the return and process the return. If you do not have a return filing requirement, but meet one of the exceptions for obtaining an ITIN (for example, individuals subject to tax treaty benefits or third party reporting or withholding), you will be required to file specific documentation instead of a tax return. Your BDO advisor can assist you with this process.

Normal filing deadlines

Individuals are taxed based on the calendar year in the U.S. (just as they are in Canada). Regardless of whether you are claiming the closer connection exception or a treaty exemption, the filing deadlines are the same. Form 8840 (to claim the closer connection exception) and the 1040NR with Form 8833 (to claim a treaty exemption) must be filed by June 15th of the following year. For 2011, you must file either Form 8840 or the 1040NR and Form 8833 by June 15, 2012. Note that if the taxpayer has employment income subject to U.S. withholding tax, the filing deadline is April 15th of the following year. The deadline for filing Form 8843 to exclude days for purposes of the substantial presence test is the same as the due date for filing the 1040NR.

Penalties

If you fail to file Form 8840 by the due date and the IRS subsequently determines that you met the substantial presence test, the IRS could require you to file a U.S. tax return. Though you can claim treaty protection from U.S. tax at the time you file the return, you would still be subject to the non-disclosure penalties under the Code. These penalties could be as much as \$1,000 for each item of income involved. Note that the Canada-U.S. Tax Treaty does not protect you from these penalties.

In addition, as mentioned above you could be subject to U.S. foreign reporting requirements if you fail to file Form 8840 on time. The penalties associated with non-compliance in connection with these requirements could be very high, depending on the applicable form.

These penalties are the main reason we encourage clients to file when required. There is usually no U.S. tax cost to filing and you can protect yourself from incurring substantial penalties at some point in the future. Your BDO advisor can assist you in preparing the necessary forms when your Canadian tax return is prepared.

U.S. resident under tie-breaker rules

If, after applying the tie-breaker rules, you are considered a U.S. resident, you would pay tax on your worldwide income in the U.S. and only be subject to Canadian tax on your Canadian source income. If you were previously a Canadian resident, that's not the end of the story.

In such a case, you would be treated as a non-resident for Canadian income tax purposes, which means that, whether you intentionally emigrated or not, you will be deemed to have disposed of most of your assets for Canadian tax purposes, and will have to pay tax on any capital gains that have accrued. The disposition will occur on the day that you tie-break to the U.S. by virtue of the tie-breaker rules in the Canada-U.S. Tax Treaty. Note that the deemed disposition rules apply to individuals who become entitled to treaty benefits after February 24, 1998. Anyone resident in the U.S. or another country other than Canada due to the tie-breaker rules in years prior to this date can continue to tie-break without triggering the deemed disposition, as long as they remain a resident, for treaty purposes, of the same country. The current rules will apply to you on the day you move to another country (other than Canada).

As these rules could affect many individuals who leave Canada for a short-term stay in another country (for example, a short-term transfer of an executive), these deemed disposition rules can be "unwound" if the individual returns to Canada

within five years. Your BDO advisor can assist you in determining how these rules apply to you.

Canadians owning U.S. rental properties

In addition to spending time in the U.S. on a regular basis, many Canadians own U.S. real property, and rent it out on either a full-time or part-time basis. The rents received are subject to a 30% withholding tax which tenants are required to deduct and remit to the IRS, even if they are Canadians or other non-residents of the U.S. The Canada-U.S. Tax Treaty allows the U.S. to tax income from real property according to U.S. domestic law, with no reduction in the general withholding tax rate. Tax at 30% is a high rate to pay on gross income.

If you have expenses associated with your U.S. real property (such as interest, property taxes and utilities), you would likely pay a much lower amount of tax if you were taxed on the basis of your net income from the property using U.S. tax brackets applicable to individuals. Fortunately, the Code allows non-residents to elect to be taxed as though their income is effectively connected with a U.S. trade or business, which means you can deduct expenses incurred to earn such income.

If you wish to deduct expenses in order to be taxed on a net income basis, you must file a U.S. tax return and meet certain other requirements. On your U.S. return (Form 1040NR), you would show the income and expenses, as well as the amount of any tax withheld. If the net tax is less than the taxes withheld, you will be able to get a refund of the excess.

Some people assume that because the election is always available and their expenses exceed their rental income, there is no need to worry about filing any U.S. tax forms or having tax withheld at source. This is not the case! If you want to take advantage of the net income election provided under the Code, you must satisfy the U.S.'s strict rules related to the timing and content of the required filings. If you fail to meet the deadlines and requirements for filing, you could lose the

right to make a net income election and, therefore, be exposed to tax at 30% on your gross rental income.

Filing requirements when making an election

To make the net income election, you must file a 1040NR, including a statement declaring that you are making the election. The election should include the statement that you are making the election, the relevant section of the Code, the address of the property, your percentage ownership, a description of any substantial improvements made to the property and details of any previous election or revocation of the net income election. Once made, the election is valid for all subsequent years and does not have to be repeated unless you acquire a new property. Keep in mind that even though the election does not have to be made every year, you must still file a 1040NR each year to report the income, expenses and any tax withheld.

It should be noted that if you own U.S. rental property, you may also be required to comply with Canada's foreign reporting requirements (Form T1135). Contact your BDO advisor for more information.

Deadlines for making the election

As noted above, the 1040NR is normally due by June 15th of the year following the calendar year in question. You can file the 1040NR late if no taxes are payable, but the net income election will generally only be valid for a particular year if the return is filed no later than 16 months after the original due date for the 1040NR return. (For corporations, the deadline is 18 months after the original due date.)

The following table summarizes the deadlines for returns of individuals for the last three years:

Taxation Year	Deadline
2009	October 17, 2011
2010	October 15, 2012
2011	October 15, 2013

Penalties

Failure to file a return within the 16-month period will result in you being subject to tax on a gross income basis for that year. That is, you will be subject to tax on the gross rents at 30%, with no deduction for any expenses incurred. The intent is to force people to file the required returns on a timely basis.

IRS Regulations provide that filing deadlines may be waived if the taxpayer establishes that based on the facts and circumstances, they acted reasonably and in good faith when they failed to file a U.S. income tax return. Taxpayers are deemed not to have acted reasonably and in good faith, however, if they knew they were required to file a U.S. income tax return, but chose not to.

Some of the factors the IRS considers in determining whether a non-filer acted reasonably and in good faith include:

- Did the taxpayer voluntarily identify himself or herself to the IRS (in other words, did they file a return)?
- Was the taxpayer honestly unaware of the filing requirements?
- Did the taxpayer previously file U.S. returns?
- Were there intervening events that were beyond the taxpayer's control which prevented filing?
- Were there other mitigating circumstances?

U.S. Estate Tax

Canadians who die owning U.S. real property could be subject to U.S. estate tax, depending on factors such as when they die, the size of their U.S. holdings and the size of their overall estate. The estate tax regime in the U.S. underwent some changes in December 2010, and under the new legislation, U.S. estate tax rates and exemption

limits are known for deaths that occur in 2011 and 2012. However, for deaths in 2013 and subsequent years, estate taxes will revert to higher rates and a lower exemption limit, unless legislative changes are introduced for these years. For further information on U.S. estate taxes, contact your BDO advisor and also see the BDO Tax Bulletin, *U.S. Estate Taxes for Canadians*, available at www.bdo.ca.

Summary

We strongly encourage all clients to comply with IRS filing requirements. In most cases, this involves simply filling out a return or statement, with no actual tax owing. It's to your advantage to maintain yourself in good standing for future dealings with the U.S. authorities, particularly if you maintain a residence or have other assets there.

Don't let the situations discussed above happen to you – ensure that all your required U.S. filings are made on a timely basis. Your BDO advisor is ready to help.

The information in this publication is current as of July 31, 2011.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact BDO Canada LLP to discuss these matters in the context of your particular circumstances. BDO Canada LLP, its partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

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