

Canadian News and Law Update

06/03/10

U.S. Tax Relief for Canadians Emigrating to the United States

Canadians moving from Canada to permanently settle in the United States should take note of recent Internal Revenue Service (“IRS”) guidance providing relief from U.S. federal income taxation.

Individuals emigrating from Canada to the United States are subject to Canada’s departure tax as if the Canadian resident had disposed of all their capital property for fair market value immediately prior to their departure from Canada (the “Departure Tax”). Thereafter, when the individuals subsequently sell such property, the United States will impose a federal income tax upon the gain from the actual sales price over the original basis. Recently, the IRS published Revenue Procedure 2010-19 (“Rev. Proc. 2010-19”) providing guidance on making a gain recognition election for U.S. federal tax purposes under Article XIII(7) of the United States-Canada Income Tax Treaty (the “Treaty”), as amended by the Fifth Protocol to the Treaty.¹ The election provides emigrants from Canada with relief from U.S. federal income tax through a deemed sale election that results in an increase in the tax basis of the property to its fair market value.

I. Double Taxation of Individuals Emigrating From Canada

Emigrating from Canada normally results in the relinquishment of Canadian tax residency. Immediately prior to leaving Canada, emigrating Canadians are subject to the Departure Tax associated with a deemed sale of property owned. Exceptions to the Departure Tax include real property owned and located in Canada, business property located in Canada if the business is carried on through a permanent establishment in Canada, pensions and employee stock option plans. However, when the person became a U.S. resident and subsequently sold the property, U.S. federal tax is imposed at the time of the actual sale based upon the original basis in the property, not the value of the property on which the Departure Tax was paid. Consequently, Canadians emigrating to the United States could be subject to double taxation.

To resolve the timing difference, a Canadian emigrating to the United States can make an election under Article XIII(7) of the Treaty to elect to be subject to U.S. federal income tax on the property as if they did dispose of the property for fair value and reacquired the property at its fair market value immediately before the deemed Canadian disposition. As described below,

¹ Revenue Procedure 2010-19, 2010-13 IRB.

Rev. Proc. 2010-19 provides procedures to obtain U.S. federal income tax relief for four categories of Canadians emigrating after September 17, 2000.

II. Prospective Elections for Property Taxable by the United States

This category primarily applies to U.S. citizens or non-U.S. citizens who own U.S. real estate or U.S. property that constitutes part of a U.S. permanent establishment.

Canadian residents emigrating to the United States after March 28, 2010, may elect to be treated as having sold and repurchased property taxable by the United States before emigrating from Canada to the United States. Property taxable by the United States includes U.S. real property, personal property forming part of the business property of a U.S. permanent establishment, and property with respect to which gain would be taxable by the United States under the saving clause of the Treaty if sold by a U.S. citizen or resident.

Example

Assume Ethan, a former Canadian resident, emigrates from Canada to the United States on April 1, 2010. At the time of emigration he was subject to U.S. tax as a U.S. citizen and owned shares of stock. He paid the Departure Tax on the shares of stock.

Rev. Proc. 2010-19 permits Ethan to recognize gain or loss for the deemed sale of the stock. U.S. federal income tax on the deemed gain would likely be offset by a foreign tax credit for the Departure Tax. Ethan's tax basis in the stock for U.S. federal income tax purposes would be its fair market value at the time of emigration from Canada.

III. Prospective Elections for Property Not Taxable by the United States

This category primarily applies to non-U.S. citizens who own non-U.S. property. Rev. Proc. 2010-19 permits former Canadian residents who are not subject to U.S. tax at the time of emigration from Canada to be treated as having sold and repurchased the property immediately before emigrating to the United States. Consequently, the basis in the property is stepped-up for U.S. federal income tax purposes.

Example

Assume Emma, a Canadian citizen, emigrates from Canada to the United States on April 1, 2010. She is not a citizen or resident of the United States and owns property in Canada.

Emma pays the Departure Tax on a deemed sale of the property she owns in Canada and makes the election for relief from U.S. federal income tax under Article XIII(7) of the Treaty. Emma will not be subject to U.S. federal income tax for the deemed sale of the property. Also, Emma's basis in the property for U.S.

federal tax purposes would become the fair market value of the property at the time of emigration. She would only be subject to U.S. tax on the appreciation of the property after emigrating from Canada.

IV. Retroactive Elections for Property Taxable by the United States

Rev. Proc. 2010-19 also provides retroactive relief for Canadian residents who emigrated after September 17, 2000, and before March 29, 2010, who sold or otherwise disposed of their property after emigrating from Canada, but before making the election for relief under Article XIII(7) of the Treaty. The election is reported on an amended U.S. federal income tax return for the year of the deemed disposition and gain recognized. The election for this third category of taxpayers is available only to the extent the year of the deemed disposition is not closed by the statute of limitations.

Example

Assume Jacob emigrated from Canada to the United States in 2008 and owned shares of stock at the time of emigration. He paid the Departure Tax on a deemed sale of the stock. In 2009, he sold the stock and reported a capital gain for U.S. tax purposes. His taxable gain without making the election would be:

CANADA	UNITED STATES
(2008) Gain Under Canada's Departure Tax:	(2009) Gain Under U.S. Capital Gains Tax:
Fair Market Value: \$30,000.00	Fair Market Value: \$30,000.00
Basis: - <u>\$10,000.00</u>	Basis: - <u>\$10,000.00</u>
Net Gain: <u>\$20,000.00</u>	Net Gain: <u>\$20,000.00</u>

Under Rev. Proc. 2010-19, Jacob may make an election for retroactive relief from U.S. tax since the Departure Tax was paid upon emigration from Canada to the United States. The election permits Jacob to retroactively increase the basis in his property for U.S. tax purposes from \$10,000.00 to \$30,000.00, the property's fair market value at the time he paid the Departure Tax. Jacob would file a 2008 U.S. income tax return and report the deemed disposition gain, likely offsetting the U.S. tax with a foreign tax credit. He would amend his 2009 U.S. income tax return to report no gain or loss on the sale of the property and request a refund of U.S. taxes paid.

V. Retroactive Elections for Property Not Taxable by the United States

This fourth category applies to non-U.S. citizens who own non-U.S. property and acquired U.S. tax residency after September 17, 2000.

Under Rev. Proc. 2010-19, the Canadian emigrant can make election to treat property as having been sold and reacquired at fair market value on the deemed disposition date. The retroactive election must be made on the individual's U.S. tax return filed after March 29, 2010, and amended tax years filed for affected tax years.

Example

Assume Tyson, a Canadian citizen, moved to the United States on February 15, 2010, and was subject to the Departure Tax on shares of a Canadian private company. Since the shares were not property taxable by the United States, Tyson files the retroactive election with his 2010 U.S. tax return. For U.S. tax purposes, Tyson acquires a stepped-up basis in the shares.

VI. Ownership of Multiple Properties

Canadian residents owning multiple properties at the time of emigration may make the election available under Rev. Proc. 2010-19 if applied consistently to all properties and the deemed disposition of the properties results in a net gain for Canadian tax purposes. No election is permitted to be made if the deemed disposition of the properties results in a net loss for Canadian tax purposes.

Example

Assume Ava is a Canadian resident and will emigrate to the United States on July 1, 2010. She owns real property in the United States and stock in Canada. The net gain from a deemed disposition of her properties for purposes of the Departure Tax is calculated as follows:

<i>Canadian Property:</i>	<i>\$200,000.00</i>	<i>gain</i>
<i>U.S. Property:</i>	<i><u>(\$100,000.00)</u></i>	<i>loss</i>
<i>Net Gain:</i>	<i><u>\$100,000.00</u></i>	

Since the net gain under the Departure Tax is \$100,000.00, Ava may make the election under Rev. Proc. 2010-19. If the deemed disposition had resulted in a net loss for Canadian tax purposes, Ava could not make an election with respect to any of the properties.

VII. Making the Election

The procedural requirements to make the election for relief under Article XIII(7) of the Treaty includes: (1) filing U.S. federal income tax returns to report the gain or loss from a deemed sale of the property at the time of emigration from Canada; (2) attaching IRS Form 8833, Treaty-Based Return Position Disclosure to a U.S. federal income tax return to make the election; and (3) providing documentation noting the fair market value of the property at the time Canada imposed the Departure Tax and proof that the Departure Tax was paid.

Once the election under Article XIII(7) of the Treaty is made, it is irrevocable unless revoked with the permission of the IRS.

For more information, please contact the Canada Practice Group at Lane Powell:

206.223.7000 Seattle

503.778.2100 Portland

lanepowell@lanepowell.com

www.lanepowell.com

We provide the *Canadian News and Legal Updates* as a service to our clients, colleagues and friends. It is intended to be a source of general information, not an opinion or legal advice on any specific situation, and does not create an attorney-client relationship with our readers. If you would like more information regarding whether we may assist you in any particular matter, please contact one of our lawyers, using care not to provide us any confidential information until we have notified you in writing that there are no conflicts of interest and that we have agreed to represent you on the specific matter that is the subject of your inquiry.

Copyright © 2010 [Lane Powell PC](http://www.lanepowell.com) www.lanepowell.com

Seattle - Portland - Anchorage - Olympia - Tacoma - London