$your wealth$

by J. Peter Hodgson CFA

It's time for some Spring cleaning but from a financial point of view.

Welcome back Snowbirds. It is time for some spring cleaning but from a financial planning point of view. This article will point you to some, but not all, of the issues you may want to consider. The best preparation will be getting the advice and opinion from qualified accountants and lawyers comfortable and experienced in these cross border matters. Investing in their opinions could save substantial amounts of money and inconvenience down the road.

There is a new administration in the US and it appears that it is a little more focused on domestic issues resulting from the economic crisis. It's approach to the GM and Chrysler restructuring show it is prepared to shake things up. The administration appeared comfortable with bending case law in order to get the result it wanted and walked over bond holders in the process. Snowbirds may want to take notice. The US is running record deficits and increased taxation usually follows. Taking for granted the tax status and estate status of Snowbirds may lead to unhappy outcomes. Someone has to help pay and perhaps who better than a non-voting, non-American.

The US taxes a Snowbird could face include, income, capital gains, dividend, gift and estate tax. Estate tax can be a hefty surprise. It could be said that Canada taxes the living and the US taxes the dead. The American philosophy, one might jest, is that it is better to tax the dead as they don't vote or complain as much.

Depending on circumstances, Snowbirds may not actually have to pay tax but they may have to file. This is determined by the residency status and ownership of US domiciles assets. They may be able to recoup US tax on their Canadian filing. What requirements and the resulting tax implications require understanding how the Internal Revenue Service (IRS) regards the residency status of the individual.

Are you a US resident in the eyes of the IRS? They have a substantial presence test. If you have spent in total 183 days in the US in the last calendar year the quick answer is yes. It does not have to be consecutive days. So three months south in the winter and a couple of winery tours could put one over the limit. The IRS also uses a weighted time test over three years. The formula adds the totals days spent in the US in the last year, 1/3 from the previous year and 1/6 of the year before. The test is a cumulative 122 days. Simply put if you regularly spend three months a year south, you qualify under the test. Remember that it does not have to be consecutive so the trip to the outlets last year could tip you over. The hopeful may rely on the fact that no one is counting, a cynic may think that the emboldened Homeland Security and new passport requirements makes the accounting a lot easier to track.

Once you have determined you meet the substantial presence test you can claim an exception under the "closer connection" rule. This may exempt you from being considered a US resident for tax purposes as it takes into consideration the location of your permanent home, family, personal effects, driver's license, voter eligibility and business connections. To apply for this exemption you must file form 8840 with the IRS by June 15th of each year. This exemption does not apply if you passed the 183 days in one year.

If you are not able to qualify under the closer connection you may be able to apply under the US Canadian tax treaty for a tie-breaker ruling to determine residency. If you need to look to the tie-breaker most likely your tax situation is more complicated than most and you should seek out the expertise of accountants that are very familiar with both US and Canadian tax rules and it may require an expert for each country.

The next areas to review are your wills and powers of attorney. Snowbirds should understand the validity of the wills and powers of attorneys in the jurisdictions they spend substantial amounts of time in. Jurisdictions may not recognize documents drawn in other areas or they may apply different interpretations on various clauses contained in the documents.

Trying to ascertain the legality of a document after it is needed can be a very expensive and frustrating exercise. Getting advice from lawyers familiar with these matters is very important to make sure there are no conflicts between documents and jurisdictions.

Most Snowbirds should have supplemental health care coverage to cover the time they are down south. A review of the coverage in conjunction with the provincial health coverage is a good exercise. A review of previously submitted health questionnaires should be done An innocent oversight on the questionnaire could lead to the denial of coverage, even on an unrelated health matter. Ensure the answers to the questions represent your situation accurately as when the time comes for payment the coverage will come under review prior to the settlement of claims. It may mean an upward revision of the cost of coverage but may pale compared to the cost of a denied health claim.

You may not be a resident in the eyes of the IRS but it does not mean you are out of the woods yet. Owning US domiciled property may yet qualify you for income, estate and gift tax. US property could be consider as real property, shares, units and debt issued by US domiciled companies, and personal property permanently in the US such as cars and boats.

If you own a property in the US and you rent it out you are required to submit 30% of the rent as a withholding tax. The tenant or the property management company is required to send to the IRS. In order to avoid surprises always check to ensure this is done. You can elect to pay tax on the net rental income rather than the gross if you do not want to pay a 30% tax but this means you will have to file a return with the IRS this will allow you to apply certain cost as deductions. If you do not file, the IRS will tax at 30% regardless of the deductions. There is a 16 month window from June 15th to file. The sale of the property and death of the owner could trigger a review of the rental status of the property and a request for back taxes owed and may include penalties.

There are withholding requirements for US stocks and bonds, usually these are managed by the firm holding the securities on your behalf. You are able to claim a credit for taxes paid on your Canadian filing.

Owning property US may expose you to US estate tax. You merely need to have property worth $60,000 US to qualify. A timeshare, a boat and a few US stocks held directly in your name could put you over the limit. This tax could be as much as 46% on the value of the property. The tax is applied to the value (not the gain on) on the US domiciled property. Exposure to and the rate of tax are determined by the value of your worldwide assets. Fortunately there are exclusion amounts based on worldwide assets that may shelter your exposure but confusingly, exclusion amounts depend on the date of death. For example if you can plan your death for 2010 then there is no estate tax as the taxes have been repealed but in 2011 as a result of a unique legislative situation, they resume with the exclusion amount set to $1 million dollars of world wide assets. Unfortunately life insurance proceeds and RSPs can be included in worldwide assets. It is very easy to accumulate enough worldwide assets to have US estate tax exposure.

There are two credits that are available to Canadian estates that may eliminate or mitigate the tax liability. The first is the pro-rated unified credit. The second is the marital credit. These are used to reduce the amount of estate tax paid on filing with the IRS. A tax credit may be available on the Canadian filing but only available to offset the gain on the property not the value. Get advice ahead of time.

To complicate matters further the amount of estate tax paid is affected by how the ownership is registered. If it is registered jointly, without survivorship, then the estate tax is applied to the proportional ownership but this does require proof of contribution of the surviving spouse. In a situation of ownership with survivorship then the entire value of the property is applied to the deceased's estate. It is very easy to pay US estate tax twice if proper planning is not done. Once on the first death and a second time on the death of the surviving spouse. ☛

There are strategies that can be applied to minimize US estate tax but it is very important to get professional help. A simple solution could be to place US security investments in a Canadian domiciled vehicle be it a mutual fund or Canadian holding company. The first is a relatively inexpensive strategy and a strong argument for using funds for US securities. The additional management expense ratio may be dwarfed buy future estate tax liabilities. Holding companies may be useful as they are not an individual and subject to death. With professional help it may be possible to roll over investments into the trust on a tax deferred basis. A trust will incur additional costs for the filing and accounting so there needs to be sufficient assets to spread the costs over to make it economical.

Life insurance death benefits may be included in worldwide assets and the attribution is based on the owner of the policy. It may be possible to transfer ownership of a policy to a trust or another individual to mitigate the estate tax. Insurance proceeds may also be used to fund remaining estate tax liabilities.

Mortgage liabilities on properties in the US in estate situations may reduce the overall tax liability as they can be used to offset against the value of the property. They must be non-recourse mortgages which mean the lender can only look to selling the property to recover funds on a mortgage default. Given the current real estate situation in the US these mortgages might be very difficult to obtain.

One more strategy is where a couple can gift property to the one spouse with the longer expected lifespan but only within a certain dollar threshold otherwise US gift tax can apply.

There may well be other options and these as well of the above are best deployed with professional help with experience in these areas. The key points for Snowbirds to recognize is that it may only take 90 days a year and $60,000 in assets south of the border to exposure them to US taxes. Many may be exposed without even knowing it and no tax authority is prepared to accept that as an answer. So please review your circumstances with a slightly different view considering your potential US income tax liabilities, the quality and enforceability of your wills and powers of attorneys, the condition of your health care policies and potential exposure to US estate tax. It is your wealth.

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