NetWorth

Tax Considerations for Canadian Snowbirds

If your retirement plan includes spending winters in the U.S., you'll have many things to consider such as who will look after your home in Canada, ensuring you have adequate travel insurance, and how you'll manage your bills and finances while you're away.

From a tax perspective, "Snowbirds" – Canadian residents who spend part of each year in the U.S. – may be considered U.S. residents for income tax purposes and be required to provide information about their financial assets to the Internal Revenue Service ("IRS").

U.S. citizens and permanent residents of the U.S. must report worldwide income on their U.S. income tax returns regardless of where they live. Even though you may only visit the U.S. for a few months every year, depending on the circumstances you may be considered a U.S. resident for U.S. tax purposes and be subject to U.S. individual income tax filing and information reporting requirements.

The U.S. Substantial Presence test

The IRS will consider you to be a U.S. resident for U.S. income tax purposes, if you meet the "U.S. Substantial Presence test."

To determine whether you meet the Substantial Presence test in the current year, count the total number of days you spent in the U.S. for the current year, then add one-third of your days spent in the U.S. from the previous year, and one-sixth of the total days spent in the U.S. from two years prior. If the sum of these days is equal to or greater than 183 days and you spent more than 30 days in the U.S. in the current year, you will have met the Substantial Presence test and may be considered a U.S. resident for U.S. income tax purposes for the current year. Generally, you will not meet the Substantial Presence test if you stay in the U.S. for less than 120 days each year.

Even if you meet the Substantial Presence test but were in the U.S. for less than 183 days during the current year, you may demonstrate that you have a closer connection to Canada and be treated as a non-resident of the U.S. by filing IRS Form 8840, also known as the "Closer Connection Exception Statement for Aliens."

If the information you provide on IRS Form 8840 supports your closer connection to Canada, you will not be treated as a U.S. resident for U.S. income tax purposes, and you will not be required to comply with U.S. income tax filing obligations.

Conversely, if you spent 183 days or more in the U.S. in the current year, you will not be eligible to claim the closer connection exemption and will have to consider relying on the "tie breaker" rules that are part of the Canada-U.S. Tax Treaty to support your claim that you are a resident of Canada.

If you're planning to travel to the U.S. on a regular basis, it's important to keep a record of your days spent in the U.S. so that you do not inadvertently become a U.S. resident for income tax purposes.

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Do you have a succession plan for your business?

A succession plan would detail the business owner's desires with respect to the management of the business and the disposition of their shares. This is very important because business owners devote a significant amount of time, energy and, in most cases, their own money to building their business. If you're contemplating a sale to a third party or a transition to family or employees, setting goals, having a vision and developing a formalized business succession plan are critical for success. A succession plan would also be useful as a contingency plan in the event of premature death, divorce, disability, disenchantment. Under some of these events the business owner is not able to manage the affairs of the business or lead the process for transitioning.

BMO's Succession Planning Roadmap

1. Assess personal and family needs, goals and vision for the business. The business owner and their family would review/establish all of their objectives in terms of retirement, working, business ownership, wealth transfer, etc. By establishing clear objectives, decisions become much clearer.
2. Business needs analysis. The business will have objectives also. What is the 5 or 10 year plan for business? What are the needs of the business in order to achieve its business plan? What are the obstacles confronting the business. As noted above, a clear business needs analysis will making decision making easier, such as family succession or third party sale.
3. Development of options. This step reviews the current resources available and the goals of the client and business. Options are developed that can achieve the objectives given the available resources. The options could then be reviewed to ascertain which achieve the client's objectives in the more efficient and effective manner. This step requires a team be assembled. The team must represent the various types of knowledge required for the situation. The team must work together to analyze the situation and develop appropriate strategies. Only by working together will the final plan address all aspects of the situation and best achieve the client's objectives.
4. Establish business value. Completing a business valuation is an important step in succession planning. Value will drive the asking price, the income tax plan, any corporate reorganization plan, and the estate plan. Knowing the value will help with option development and choosing the right option.
5. Retirement planning. A plan will ensure that the appropriate level of assets are segmented for retirement, which could free up other assets for succession planning or estate planning.
6. Estate and tax planning. Tax minimization and asset conversation are common objectives of estate planning. The family's intergenerational wealth plan will develop from the estate plan.
7. Prepare for sale or transition. The phases in completing a third party sale are; review of information systems, review of management structure, review of financial statements, general corporate housekeeping and operational analysis.
8. Family transition planning preparation. The phases for a family succession are roughly the same as a third party sale but would also include a systematic review of the skill required to succeed and the skills in the next generation.
9. Finalize wealth management plan. The wealth plan pulls all of the pieces together. By carefully reviewing the wealth plan the family can see the financial results of their decisions and will be able to gain confirmation that they are on the right track.

For business owners, the company is their most important asset, requiring thoughtful consideration and planning with respect to the

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next generation who, may or may not, carry on the family business. Whether the company is retained within the family, expanded by acquisition or sold to a third party, proper planning will ensure that the family's goals and objectives can be met.

What to ask yourself?

- Where do I see myself, the family, the business in 5 or 10 years?
- How am I going to be able to have more time away from the business?
- How much is the business worth? What are the value drivers for the business?
- Can the next generation grow the business or is it best to sell the business?
- What would happen if I couldn't get into the business for 12 weeks?

Tax Planning Using Private Companies

As noted in our 2017 Federal Budget summary, the federal government indicated that it would review the use of certain tax planning strategies involving private corporations that it perceives unfairly reduce personal taxes of high-income earners through a variety of tax reduction strategies unavailable to other Canadians. On July 18, 2017, the government followed up on its review of private corporation taxation by releasing a consultation paper which sets out the nature of its concerns and proposed policy responses, which was open for consultation until October 2, 2017.

Proposed Measures

The following measures proposed in the consultation paper are very wide-ranging in their potential impact to private corporations. They affect many common tax planning strategies employed by family businesses and professional corporations, and seek to limit many of the current tax benefits of incorporation.

1. Income-splitting

The Government is concerned with the widespread use of income-splitting strategies involving private companies, particularly where individuals enriched are not actively involved in the business.

a) Extension of the "kiddie tax" (Tax on Split Income)

New proposals released as draft tax legislation in the consultation paper include an extension of this existing tax on split income for minors (i.e., kiddie tax) to also apply to adults (of any age) in certain circumstances after 2017, as follows:

- Dividends and other amounts received from a business by an adult family member of the principal of the business, may be subject to a reasonableness test which will be stricter for those aged 18 to 24.
- The reasonableness test will be based on the contributions made (e.g., labour and capital) by the family member to the business, taking into account previous returns/remuneration, in light of the appropriate compensation that would be provided to an arm's-length person for similar contributions.
- To the extent the amount is not reasonable, the top tax rate will apply to the dividend income, regardless of the individual's actual marginal tax rate.

Other changes proposed are intended to improve the existing kiddie tax rules and support these additional measures, including expanding these rules to encompass reinvested "compound" income on affected distributions received by individuals under age 25, and gains from dispositions after 2017 of certain property, the income from which is considered "split income."

b) Restrictions on the multiplication of the lifetime Capital Gains Exemption (CGE)

In conjunction with the government's intent to limit the tax benefits of family members not actively involved in the business, another specific concern of the government is the use of family trusts to "multiply" access to the CGE limits (currently $835,716 for 2017) to other family members to reduce capital gains tax.

Three general measures are proposed to address CGE multiplication, as follows:

- First, individuals would no longer qualify for the CGE in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18 years.
- Second, the CGE would generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income (as part of the expanded kiddie tax provisions previously discussed).
- Third, subject to certain exceptions, gains that accrued during the time that property was held by a trust would no longer be eligible for the CGE.

These proposed measures would apply to dispositions after 2017. However, special transitional rules are also proposed.

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2. Passive investment income

Active business income earned by a Canadian-controlled private corporation is generally taxed at the small business corporate income tax rate, which is significantly lower than the highest personal income tax rate. As a result, to the extent a small business owner or incorporated professional retains a portion of their business earnings within the corporation, they are able to defer paying significant income tax until a later date when the funds are withdrawn, thereby providing additional funds that could be invested by the corporation to generate investment income.

Because of this deferral advantage available to many incorporated business owners that is not available to individuals, the government is concerned with the ability of high-income Canadians to invest more (after-tax) funds within their private corporation in 'passive' investments (versus reinvesting in the business) than what would be available after-tax if the business income was earned personally. The government is of the view that fairness and neutrality require that private corporations not be used as a personal savings vehicle for the purpose of gaining a tax advantage. As such, it is seeking to ensure that passive investments held within privately-controlled corporations be taxed at an equivalent rate to those held outside such corporations.

Accordingly, the government is proposing fundamental changes to the current tax system of "integration" which aims to ensure that an individual is indifferent between earning income through a corporation or directly. It has therefore introduced several approaches for review and consultation to establish what it perceives as greater fairness in the tax treatment of passive investment income of a private corporation, so that the benefits of the corporate income tax rates are directed towards investments focused on growing the business, rather than conferring a personal investment advantage to the corporate owner.

Specifically, it is the government's intention that the proposed approach would:

- eliminate the tax deferral advantage on passive income earned by private corporations;
- preserve the intent of the lower corporate taxes to support growth and jobs;
- ensure that private corporation owners do not have access to tax preferred savings options not available to others;
- make the system neutral on a go-forward basis; and
- limit, to the extent possible, the complexity of these new rules.

At this stage, no draft legislation has been introduced, instead the government announced that it will be seeking the feedback of stakeholders on the design considerations associated with each of the possible approaches introduced. The government intends to release a detailed proposal following these consultations, and indicated that it will provide time before any proposal becomes effective.

3. Converting income into capital gains

The government is also concerned with the use of certain complex tax strategies by higher-income individuals to reduce their income taxes by converting dividends (and salary) that would otherwise be received from private corporations into lower-taxed capital gains. Although there is an anti-avoidance rule that deals with transactions among related parties aimed at converting dividends and salary into lower-taxed capital gains, this rule is often being circumvented. Accordingly, the government has proposed amendments to this rule to address such tax planning practices. Specifically, effective as of July 18, 2017 – the date of the consultation paper – the government proposes that:

- This anti-avoidance section be amended to prevent individual taxpayers from using non-arm's length transactions that 'step-up' the cost base of shares of a corporation in order to avoid its application on a subsequent transaction.
- The Income Tax Act be amended to add a separate "anti-stripping" rule to counter tax planning that circumvents the specific provisions of the tax law meant to prevent the conversion of a private corporation's surplus into tax-exempt, or lower-taxed, capital gains.

Summary

The income tax measures introduced in the consultation paper are only proposals at this stage, and may not ultimately be enacted into law. Please stay tuned for future updates following the government's response to the submissions received during the consultation period, which ended recently.

If you have any questions regarding these proposals, please consult with your tax advisor for specific advice and direction on how your particular situation may be affected by these potential changes in the tax law.

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