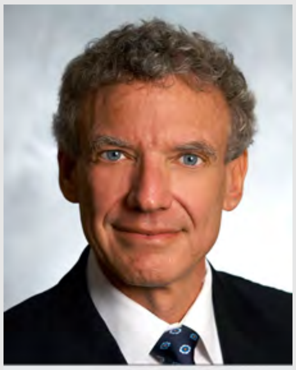
Moving to Canada: Immigration and Tax Considerations

by Jack Bernstein and David Garson



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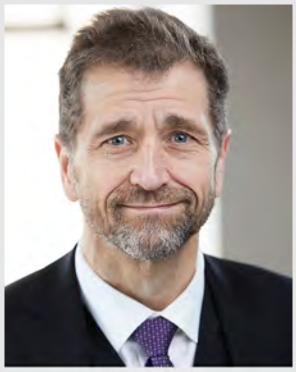

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In this article, the authors discuss the tax implications of relocating to Canada and provide advice to prospective residents.

With the COVID-19 pandemic still happening around the world, there are numerous restrictions on immigrating to Canada. The Canadian border is to remain closed to nonessential travel until at least the end of November. The restrictions are extended every 30 days, and quite bluntly, we do not see them ending any time soon.

Canada has issued two orders in council to govern the temporary entry of individuals. One order addresses entry from the United States, and the other covers entry from the rest of the world.

Canada is still processing applications for temporary and permanent residence. However, only individuals coming from the United States who do not require a visa to enter Canada can apply for their work permits at the port of entry if they are entitled to do so. All others would have to apply for the work permit through a Canadian consulate abroad, even if they do not require a visa to enter Canada. Those temporary measures are in place until we are on the other side of COVID-19.

There are still permissible reasons to immigrate to Canada both temporarily and permanently, particularly when it comes to immigration for essential work purposes. Below, we review some essential business immigration scenarios and provide insight into the potential tax implications of each.

Temporary Residence: Work Permits

With temporary work permits, there are multiple options for bringing employees to Canada.

Intracompany Transfers

International companies looking to temporarily transfer employees to Canada to improve management, expand Canadian exports, and enhance competitiveness can do so under the intracompany transfer category. Because the individuals are qualified workers providing a benefit to the Canadian economy, companies with applicants under the intracompany transfer category are exempt from the labor market assessment process.

To qualify, applicants must be employed with a multinational company with a parent, subsidiary, or affiliate in Canada. Further, the applicant must be working in an executive, senior management, or specialized knowledge capacity once in Canada.

Start-Up Companies

For new companies opening in Canada, it is also possible to apply for temporary residence under the intracompany transfer heading. A start-up company will be assessed based on the following factors:

- The company must have secured a physical location in Canada for the place of business. There are exemptions in some cases involving the transfer of senior executives, for which it will be sufficient to use a temporary address, such as the business's Canadian counsel.
- The company must be able to provide a realistic plan, and the financial resources for staffing and compensating staff, for the Canadian business.
- The company must demonstrate that it will have a large enough presence in Canada to support management and executive roles, and that it is expecting to be doing business in Canada to support transfers of employees with specialized knowledge.

The U.S.-Mexico-Canada Agreement

If an employer in Canada wants to petition for a temporary worker who maintains U.S. or Mexican citizenship, it may be possible under the U.S.-Mexico-Canada Agreement, which lists allowed professions. If someone will be performing the duties and responsibilities of the role and has the requisite educational or work-related requirements, obtaining a permit under the agreement is a possible route.

U.S. citizens can apply for those work permits at the port of entry and can initially obtain status for up to three years.

The Canada-EU Free Trade Agreement

The Canada-European Union Comprehensive Economic and Trade Agreement, much like the U.S.-Mexico-Canada Agreement, has immigration provisions. The two are different, however, in that the Canada-EU agreement is not as permissive regarding temporary work permits and the length of status granted is limited to one year with a possible discretionary renewal. Further, the professional applicant must be an independent contractor, not a direct employee of the Canadian company.

There is also provision for a European company without a Canadian entity to send an employee to Canada for a year to complete duties for clients in Canada.

Labor Market Impact Assessment

In the normal course, if a company in Canada wishes to petition for a temporary worker, it would first have to obtain a labor market impact assessment from Service Canada. That involves advertising the position and satisfying Service Canada that there were no appropriate candidates in the country. Once an assessment is obtained, the actual application for a work permit can be made.

That process is used when the applicant cannot file in another category, such as under an intracompany transfer or a trade agreement. It is one of the more difficult categories and requires a fair amount of preparation.

Canada is still adjudicating work permits at the port for individuals coming from the United States to determine if they qualify for this type of application. Officers may want to be satisfied that the work could not be done remotely and that personal attendance is required.

Permanent Residence for Work Purposes

Express Entry

Express Entry is a program through which skilled workers and tradespeople can apply for permanent residence based on the contributions they could make to the Canadian economy. Some provincial nominee programs have application streams that are connected to the express entry program.

Express entry covers three federal programs, each of which requires specific work experience to qualify.

Canadian Experience Class

Applicants applying for express entry under the Canadian experience class must have worked at least one year in Canada in the three years preceding their application. Applicants must meet language communications levels, and their skills must qualify them for managerial or professional roles, or a skilled trade. There is no minimum educational requirement under the program; however, both foreign and local educational achievements will advance an applicant's competitiveness in the express entry pool for consideration to receive an invitation to apply.

Federal Skilled Worker Program

Applicants applying for express entry under the federal skilled worker program do not have to have Canadian work experience but must meet a minimum-points threshold based on six selection factors: age, education, language, skilled work experience, existing job offers, and adaptability. Applicants must also be able to demonstrate they have sufficient financial funds to settle in Canada or have a valid job offer there.

Federal Skilled Trades Program

The federal skilled trades program is available to those in the following trades:

- industrial, electrical, and construction work;
- maintenance and equipment operation;
- supervisors and technical jobs in natural resources, agriculture, and related production;
- processing, manufacturing, and utilities supervisors or central control operators;
- chefs and cooks; and
- butchers and bakers.

Permanent Residence via the Start-Up Program

As discussed above, it is possible to come to Canada temporarily to facilitate the start-up of a new business venture of an existing international business. However, there is also an option under the start-up visa program for people to immigrate to Canada permanently to begin a new business venture.

Several conditions must be met to qualify for admittance under this program:

- Applicants must have a letter of support from a designated entity (for example, angel investor or venture capital fund) capable of providing financial support for the new venture. The initial commitment must be between C 75,000 (about US $56,000) and C 200,000, depending on the entity.
- Applicants must be able to demonstrate an ability to communicate in English or French.
- Applicants must submit proof of sufficient financial resources to support themselves and their families after landing in Canada. This money must not create a debt for the applicant. This means that the applicant cannot borrow the money that they would use to establish themselves, for example, demonstrating that they posses a line of credit that they will rely on.
- Applicants and their families must be legally admissible to Canada.

Tax Planning for Immigration to Canada

Canada's political stability and economy make it a logical choice for people wishing to immigrate from the United Kingdom, Hong Kong, the Middle East, South Africa, and other jurisdictions. Also, Canada continues to be a destination for executives of multinational companies and for U.S. companies to temporarily relocate their executives. The election of Donald Trump as the U.S. president prompted queries from many Americans regarding Canada's immigration requirements. Given the demand for Canadian residency and high Canadian personal tax rates, tax planning is an important issue for prospective newcomers.

Residency

A resident of Canada is subject to Canadian income tax on his worldwide income. A person will become a resident of Canada when he moves to Canada with the intention of residing there. Any person like that is considered ordinarily resident in Canada.

The precise date of becoming a resident may depend on the date the person becomes a landed immigrant, moves to Canada, or begins employment in Canada. For the year of immigration, the immigrant will be taxable in Canada on Canadian-source income received before the date of immigration and on worldwide income earned after the date of immigration. The immigrant's first tax return must be filed by April 30 of the year following the year of arrival. Personal exemptions will have to be prorated based on the time spent in Canada.

A person who spends more than 182 days in a year in Canada may also be deemed resident in Canada for that year under the sojourning rule in section 250(1)(a) of the Income Tax Act (Canada). However, that person may use the tiebreaker clause in Canadian tax treaties to argue that he is a resident of another country and thereby relieve himself of Canadian residency.

For an individual who is concerned about being deemed resident in Canada under the sojourning rule, all travel days to and from Canada are counted. The Canada Revenue Agency considers those days to contribute to the determination of the number of days an individual has sojourned in Canada in a calendar year. ITA section 250(1) states that a person shall be deemed to have been resident in Canada during a tax year if he sojourned in Canada in the year for a period of, or periods that total, at least 183 days. Paragraph 1.33 of Income Tax Folio S5-F1-C1, "Determining an Individual's Residence Status," states that the CRA considers any part of a day to be a day for determining the number of days an individual has sojourned in Canada in a calendar year. In other words, the CRA does not consider the time of day a person enters or leaves Canada in determining whether he has sojourned in Canada for at least 183 days in a year. Instead, the CRA will consider only the actual date of departure or arrival.

Other relevant parts of paragraph 1.33 of Income Tax Folio S5-F1-C1 state:

> 1.33 An individual is not automatically considered to be sojourning in Canada for every day (or part day) that the individual is present in Canada; the nature of each particular stay must be determined separately. To sojourn means to make a temporary stay in the sense of establishing a temporary residence, although the stay may be of very short duration. For example, if an individual is commuting to Canada for his or her employment and returning each night to his or her normal place of residence outside of Canada, the individual is not sojourning in Canada. On the other hand, if the same individual were to vacation in Canada, then he or she would be sojourning in Canada and each day (or part day) of that particular time period (the length of the vacation) would be counted in determining the application of paragraph 250(1)(a). In distinguishing a commuter from a sojourner, relevance should be placed on the country in which an individual spends his or her time away from work. In other words, an individual who comes to Canada for work purposes may nevertheless be considered sojourning in Canada if that individual does not leave the country to spend his or her time away from work.

The CRA takes the position that the most important factor in determining whether an individual entering Canada becomes resident in Canada for tax purposes is whether he establishes residential ties with Canada. An individual's spouse, dependents, and dwelling place, if in Canada, will almost always constitute significant ties with Canada. Also, when an individual entering Canada applies for and obtains landed immigrant status, the CRA will usually find that to constitute a significant residential tie with Canada.[1] If an individual's family is in Canada and he has a dwelling place available to him there, he will likely be considered factually resident in Canada and a dual resident for tax purposes. However, the analysis does not stop there. An individual will be deemed a nonresident of Canada for tax purposes if, even though otherwise factually resident in Canada, he is considered to be resident in the other country under a treaty's tiebreaker rules.

The tiebreaker rules are typically found in treaty article 4(2). The first rule is the permanent home test, which provides that an individual will be resident for treaty purposes in the country where he has a permanent home available to him. Suppose an individual has a permanent home outside Canada and is expecting to purchase a home for his wife and children in Canada. He will have a permanent home available to him in both Canada and the other country, which produces a neutral result. Consequently, his residency would be determined under the second tiebreaker rule, which is the center of vital interests test.

The center of vital interests test requires an examination of an individual's personal and economic ties with Canada and the other country to determine which country's ties are closer. The personal and economic ties to be examined are similar to those used in determining an individual's factual residence for Canadian tax purposes. The CRA lists the following as significant personal and economic ties that it will consider:

- family and social relations;
- occupations;
- political, cultural, or other activities;

[1]Despite the Federal Court of Appeal's decision in *Guo v. Canada*, 2004 FCA 390, which stated that residence for tax purposes is not simply a matter of a person's immigration status, although a person's status may be some evidence of residence.

- place of business; and
- the place from which an individual will administer his property.

That list is not exhaustive or conclusive; however, because the CRA has listed those factors, they are likely important.

To postpone Canadian residency, an individual should minimize the following ties to Canada:

- personal property in Canada;
- social ties with Canada;
- economic ties with Canada;
- work permits in Canada;
- hospitalization and medical insurance coverage from a Canadian province or territory;
- a driver's license from a province or territory; and
- a vehicle registered in a province or territory.

Further, an individual should spend the least possible time in Canada while he settles his family there before returning to the other country.

It is important for an individual to understand that he may enter Canada with his landed immigrant status, but that when he leaves Canada he cannot return without a visa or permanent resident card. Typically, a permanent resident card will be issued to an individual and sent to a Canadian mailing address within 90 days from the date the individual enters Canada with his family. Therefore, the individual must understand that when he leaves Canada to return to the other country, he will not be able to return to Canada for approximately three months until he receives his permanent resident card.

An individual who immigrates to Canada will be a resident of Canada for only a part of the year unless he immigrates January 1. The income of a part-year resident is determined under ITA section 114. Essentially, a part-year resident is taxed on worldwide income for the portion of the year in which he was a resident of Canada and on Canadian-source income for that part of the year in which he was a nonresident of Canada.

Section 114 treats an immigrant as having a tax year that includes the part of the year during which he was resident in Canada, as well as the part of the year when he was a nonresident but had income from Canadian sources. The immigrant is treated as a nonresident until the date residence is assumed and is taxable on worldwide income for the balance of the year.

An individual becoming a resident in Canada benefits from an increase in the tax costs of all properties to the fair market value at the time the individual became resident in Canada. Canada will not tax the accrued gain on those assets. Excluded from the step-up in tax costs is taxable Canadian property, inventory used in a business in Canada, and eligible capital property on an excluded right in interest and employee stock options. A U.S. citizen will continue to remain liable for U.S. tax based on historic cost.

In view of the part-year rule, an immigrant might want to consider the timing of commencement of residency in Canada. For example, if an individual immigrating to Canada from the United States is considering selling a business in the United States, he might want to consider whether the tax payable will be more as a U.S. or Canadian resident. For example, a person who has worked in the United States on a visa and plans to sell shares of a private company that is not a real property holding company may avoid both U.S. and Canadian tax by moving to Canada the year before the sale.

A person resident in Canada who moves to another country will be subject to a departure tax in Canada. Basically, there is a deemed disposition of all assets other than Canadian real estate, Canadian resource property or timber resource property, capital property and inventory used in a Canadian business, employee stock options, and rights to pension income.

Some relief is available to a person who leaves Canada within five years of immigrating. The exemption is for an individual who resides in Canada for less than 60 months during the 10 years before departure. Property owned by an individual at the time of immigration is exempt from departure tax in those circumstances, as is a gift or bequest of assets received during the period of Canadian residency.

Employee Stock Options

Employee stock options granted to an employee while a nonresident of Canada are not eligible for the increase in tax cost on becoming a

Canadian resident. A taxable benefit will arise in Canada on the exercise of the option equal to the difference between the FMV of the shares acquired in the exercise and the amount paid by the employee to acquire the shares and the option. That will apply to options granted while an employee was nonresident in Canada but exercised after becoming resident in Canada. Assuming the employee will benefit from a lower tax rate, employee stock options granted to nonresidents for services performed outside Canada should be exercised before becoming a Canadian resident. U.S. issues for employee stock options are discussed below.

Taxation of Dividend Reinvestment Plans

Reinvestment of Dividends in Additional Shares

Dividends that are used to buy more shares in the shareholder's name (under a formal dividend reinvestment plan (DRIP) or otherwise) are taxable to a Canadian resident shareholder even though they are not received in cash.

DRIPs raise other issues under the shareholder benefit provisions in ITA section 15(1). Namely, if the DRIP would permit the shareholder to purchase additional shares for an amount less than their FMV, section 15 could apply on the basis that a taxable benefit has been conferred on the shareholder in the amount of the discount at the time the shares are purchased. Section 15(1)(c) provides that section 15(1) does not apply when the corporation confers on all owners of common shares identical rights to acquire additional shares of the corporation.

In some cases, not all common shareholders can participate in the DRIP (for example, because of securities law preclusions), so that not all owners would have identical rights to acquire as required under section 15(1)(c). In those cases, it is long-standing CRA practice that a section 15(1) benefit will not be assessed for a benefit arising from the reinvestment of dividends in additional shares under the DRIP if the amount paid for the additional shares is not less than 95 percent of their FMV. However, that practice will not be applied to a benefit arising from the acquisition by a shareholder of additional shares for an amount that is less than their FMV under an optional purchase component or second round acquisition of a DRIP (for example, if the DRIP permits the acquisition by a shareholder of shares that were not subscribed for by other shareholders in the first round of the DRIP).

Decision of Directors Not to Pay Dividends

If instead the question concerns a foreign holding company holding foreign assets that would not pay dividends to the individual while he is resident in Canada, the answer will depend on whether the shareholder controls the company. If so, the foreign holding company would be a controlled foreign affiliate and the individual would be taxable in Canada regardless of whether dividends were distributed if the controlled foreign affiliate earned foreign accrual property income, being income from property or from a nonactive business. If the controlled foreign affiliate earned income from an active business carried on in a designated treaty country, or a country that has signed a tax information exchange agreement with Canada, the Canadian resident would not be taxable in Canada unless dividends were received. If the shares were held by a Canadian holding company rather than personally, the individual would be taxable in Canada until dividends were received from the Canadian holding company.

Offshore Investment Fund Property

If the foreign holding company is not a controlled foreign affiliate, the question is whether the company's shares would be considered an offshore investment fund property (OIFP) under ITA section 94.1(1). To be an OIFP, the shares of the foreign holding company would need to be considered to derive their value directly or indirectly from portfolio investments of that or another foreign entity in assets that include any combination of the following:

- shares;
- indebtedness;
- interests in one or more corporations, trusts, partnerships, organizations, funds, or entities;
- commodities;
- real estate;
- Canadian or foreign resource properties;

- non-Canadian currency; and
- rights or options to dispose of any of the foregoing.

Also, it must reasonably be considered that one of the main reasons for holding the interest in the foreign holding company is to pay less tax than if the portfolio investments were held directly. Unless that purpose test is met, the shares of the nonresident holding company would not be an OIFP. When the nonresident holding company was in place well before a move to Canada was contemplated, it is difficult to see how the purpose test could be met.

When shares of a nonresident company are an OIFP, there is an annual imputed return based on the tax cost of the shares for Canadian tax purposes multiplied by a specified interest rate (the prescribed rate plus 2 percent), whether or not any dividends are received from the company.

Those rules also apply to investment in offshore funds (shares, debts, and other interests). ITA section 94.1(1) might also apply to investments held directly in foreign funds (other than partnerships). However, if they are owned before the individual emigrated to Canada and there was no Canadian tax purpose to their acquisition, there is a strong argument that the purpose requirement of section 94.1(1) should not be met.

Life Insurance Policies

Canada has beneficial tax rules for exempt life insurance policies. Income accumulating in those policies is not subject to tax. The exemption usually applies to whole life insurance policies issued by Canadian insurance companies. A policy issued by a non-Canadian insurance company will not qualify as an exempt policy, and the owner who is a Canadian resident will be taxed annually on a market-to-market basis on income accumulating in the policy. Life insurance proceeds are not subject to Canadian tax.

Foreign Reporting Requirements

The foreign reporting rules in the ITA require most taxpayers who hold specified foreign property with a cost over C $100,000 to report that property annually. Some taxpayers and foreign property are exempt from those reporting requirements.[2] Taxpayers with foreign affiliates are also subject to the reporting requirements. The foreign reporting rules do not apply to personal-use property of a person or partnership and therefore do not require reporting of foreign residences used for personal purposes. However, that exemption does not apply to foreign residences owned by foreign corporations.

The annual reporting requirements are intended to discourage Canadians from attempting to hide assets offshore in foreign trusts, corporations, or investments. The reporting requirements provide the CRA with an opportunity to audit additional offshore transactions to either challenge them based on deficiencies in their structure or recommend that changes in the legislation be made to curb abuses. To ensure compliance, large penalties may result for any violations of the reporting requirements. Significant resources are being provided to the CRA to detect and penalize unreported and untaxed foreign property holdings.

The foreign reporting requirements have the following effects:

- taxpayers with interests in foreign property such as shares, bank accounts, and real property (other than personal-use property) in excess of C $100,000 will be required to report and provide details of those holdings;
- taxpayers with foreign affiliates (FA) (generally, a nonresident corporation if at least 1 percent of any class of shares is directly or indirectly held by the taxpayer and of which at least 10 percent is directly or indirectly held by the taxpayer and non-arm's-length persons) will have to provide additional financial and tax information on each controlled FA (generally, an FA that is actually controlled by the taxpayer or that would be controlled under specific deeming rules);
- beneficiaries of specified nonresident trusts will have to file an information return for the year in which they receive a distribution or a loan from those trusts;

[2]The specific exemptions are in the definitions of the terms "specified Canadian entity" and "specified foreign property" in ITA section 233.3.

- a partner entitled to at least 10 percent of the partnership income is subject to reporting requirements;
- persons who have transferred or loaned property to a nonresident trust will be required to file an annual information return regarding the trust; and
- persons must report transactions or series of transactions that relate to a business carried on in Canada in which they participated with a non-arm's-length nonresident.

An individual (other than a trust) is not required to file information returns reporting any of the above in the tax year in which that individual first became resident in Canada, but reporting is required for subsequent years.

Immigration Trusts

Until recently, an immigration trust was a common planning structure used by prospective residents of Canada to exempt themselves from tax on some income and capital gains for a period of up to 60 months after immigration. However, the government amended the ITA to remove the tax benefits available to newcomers through the immigration trust structure. In particular, immigration trusts will now be subject to the Canadian nonresident trust rules so that they are no longer exempt (and eligible for the resulting beneficial tax treatment). That change significantly affects planning for new residents and prospective immigrants.

Nonresident Trust Rules

The general thrust of the nonresident trust rules in ITA section 94 is to ensure that income earned indirectly by Canadian taxpayers through foreign trusts is subject to tax in Canada so that it would have been taxed had it been earned directly by the Canadian taxpayer. The rules generally apply if a nonresident trust has a resident contributor or a resident beneficiary as defined in section 94(1). The CRA generally regards a foundation formed in Panama, Liechtenstein, or elsewhere to be a trust for Canadian tax purposes.

The definition of resident contributor includes all persons who, at the determination time, are resident in Canada and contributors to the trust. A contributor is defined in section 94(1) as a person who has made a contribution to a trust. A contribution is in turn defined as a transfer or loan of property to a trust, whether made as a direct transfer or through a series of transactions. Arm's-length transfers (as defined) are excluded from being a contribution.

Section 94(1) defines a connected contributor as a contributor to the trust other than a person who made contributions to the trust only at a "nonresident time." That definition also removes the previous exclusion for immigration trusts. Section 94(1) defines "nonresident time" as a time at which the relevant person made a contribution to the trust that is before the particular time and at which the person was nonresident if the person was nonresident throughout the period that began 60 months before the contribution time and ends at the earlier of 60 months after the contribution time and the particular time. In essence, the definition requires that the contributor be a nonresident for a period beginning 60 months before the contribution and ending at the earlier of 60 months after the contribution and the determination time.

Prospective residents who are contributors to a foreign trust or beneficiaries of those trusts may subject those trusts to Canada's nonresident trust rules if they fall in the definition of resident contributor or resident beneficiary. While limited planning may be possible in this context, the resident contributor definition in particular allows for limited opportunities to plan out of the rules.

Canada will deem a nonresident trust to be resident in Canada and subject to Canadian trust tax on its worldwide income if the trust has only Canadian resident trustees (be careful if the sole trustee moves to Canada) or the trust is managed and controlled from Canada.

Tax Issues for U.S. Citizens

There are special Canadian and U.S. tax considerations for U.S. citizens and green card holders immigrating to Canada.[3] It is assumed that the individual will be deemed resident in

[3] Although this article refers to U.S. tax laws and requirements, it is not meant to be a discussion of U.S. tax rules, and the authors disclaim complete knowledge of those rules. Taxpayers should consult their own U.S. tax advisers regarding the impact of U.S. tax laws on immigration to Canada.

Canada under the Canada-U.S. income tax treaty. As a U.S. citizen or green card holder, the person will be required to continue to file U.S. tax returns.

Passive Income

For U.S. purposes, the personal foreign investment company and subpart F rules will continue to apply to the U.S. citizen or green card holder immigrating to Canada. To avoid the harms of those provisions, the U.S. citizen or green card holder may wish to ensure that all investment income is annually distributed to him.

Also, the Canadian foreign accrual property income rules will operate to attribute undistributed foreign passive income earned in an offshore (non-Canadian) corporation or trust to the U.S. citizen-Canadian resident.

Reporting Requirements

Canada taxes income based on residency, not citizenship. Thus, an immigrant to Canada will be required to file tax returns and pay tax based on his residency in Canada unless he earned Canadian-source income or disposed of taxable Canadian property as a nonresident. In Canada, each individual must file a separate tax return. There are personal tax credits available including a marital credit. There are no joint returns available in Canada for married individuals. In contrast, married individuals may be able to file a joint tax return in the United States.

If a U.S. citizen must file both Canadian and U.S. tax returns, he will be subject to the higher tax of the two jurisdictions. Attempts to shelter income are often frustrated as a result of the different deductions that may be claimed on each return. Investments based on favorable provisions of the ITA — for example, flow-through shares — may be of no or little benefit to a U.S. citizen because a deduction for Canadian tax might not be available on the U.S. return.

Some relief may be available for earned income. A U.S. citizen may claim the foreign earned income exclusion and not be subject to U.S. tax on up to US $101,300 for 2016 of earned income subject to satisfying all the qualifications to be eligible for the exclusion.

Foreign tax credits should provide some relief against double taxation. However, an FTC for Canadian tax may generally not be claimed in excess of the U.S. tax that would have been payable on the income. As a result, the higher tax rate of the two jurisdictions will apply.

Employee Stock Options

The treatment of employee stock options and other benefit plans is different in Canada than in the United States, although the Canada-U.S. treaty clarifies the sourcing of stock options between the two countries. Paragraph 6 of the diplomatic notes forming Annex B to the fifth protocol states that stock option benefits will be apportioned based on the employee's principal place of employment. Thus, the income from a stock option will be apportioned for tax purposes between the two countries based on the days (from the grant to the exercise or disposition of the options) on which the individual's principal place of employment was in a particular country. For example, if an individual's principal place of employment was Canada on 70 percent of the occasion between the grant and exercise of an option and the United States on the other 30 percent, 70 percent of the income from the stock option will be taxable in Canada. The fifth protocol does not define "principal place of employment," but it may mean the place where the employee performs most of his services or reports for work most of the time. The competent authorities may, however, attribute income differently if they agree that the grant of an option was effectively a transfer of ownership of the securities — for example, because the options were in the money.

If an employee dies while holding stock options in the United States, any employment income regarding the options will be deemed income from property in the United States. That ensures that Canada will provide an FTC for U.S. estate taxes levied on death.

Gift Tax and Estate Freezes

Canada does not impose gift or estate taxes; gifts of property to family members are deemed to occur at FMV. For Canadian tax purposes, at the instant before death, there is a deemed disposition at FMV of depreciable and nondepreciable capital property and land inventory unless a rollover to a spouse or an exclusive spouse trust is available. Although Canada does not impose gift tax, a U.S.

citizen resident in Canada will be subject to U.S. gift tax. A gift tax is not creditable for Canadian tax purposes. Also, the Canada-U.S. treaty does not offer any relief for gift tax against Canadian income tax.

U.S. gift tax may also be payable on a Canadian estate freeze. A typical estate freeze in Canada involves the issuance of redeemable and retractable fixed-value preferred shares that may not pay a dividend followed by the issuance of common shares to the next generation or to a trust for minimal consideration. Although an estate freeze is easy to achieve for Canadian tax purposes, in a typical Canadian freeze, fixed value preferred shares are issued to the founder in exchange for common shares. If the founder is a U.S. citizen the freeze may trigger U.S. gift tax because the United States will probably treat the freezer as having made a gift equal to the entire value of the company. That is because the preferred interest would be valued at nil. To avoid U.S. gift tax, the frozen preferred shares must yield a reasonable cumulative dividend and new common shares should be issued for consideration.

The United States does, however, offer some exclusions from gift tax, indexed annually. For 2016, the exclusion from tax on a gift to a noncitizen spouse is US $148,000 and US $14,000 to other recipients, subject to a lifetime gift tax exemption of US $5.45 million.

Capital Gains Exemption

A U.S. citizen who resides in Canada may benefit from a C $830,000 capital gains exemption on the disposition of shares of a qualified small business corporation or qualified farm property. However, the capital gains exemption will not be recognized for U.S. tax purposes. The individual may, however, qualify for the long-term capital gains rate (23.5 percent) in the United States.

Corporate Holdings

If a U.S. citizen wants to invest in a Canadian venture or hold an interest in a Canadian holding company, U.S. entities such as a limited liability company should generally not be used. There is a risk of double tax because payments from Canada to a U.S. entity would be subject to Canadian withholding tax. Canada treats the LLC as a corporation for Canadian tax purposes. The Canadian resident will be fully taxable on all distributions from an LLC. Although the Canada-U.S. treaty provides relief to the members of an LLC, Article IV(6) might not apply to a U.S. citizen resident in Canada and investing in Canada through an LLC.

If a U.S. citizen or green card holder moves to Canada while continuing to hold shares of an LLC, the tax consequences might be unfavorable if the income from the LLC is considered as FAPI in Canada. Canada will continue to treat the LLC as a corporation for taxing any inbound income to the immigrant from the LLC, thereby creating the possibility of FAPI and an immediate income inclusion. The immigrant will be taxed on the income of the LLC as earned (if FAPI) but should be entitled to an FTC in Canada (assuming the individual has other U.S. income to apply the FTC against because FAPI might not be distributed in the year in which it is included in the individual's income). If a Canadian holding company is formed to hold the shares of the LLC, it will not be entitled to any FTC in Canada regarding income from a share of the LLC or foreign affiliate (including any undistributed income considered FAPI for Canadian tax purposes).

A Canadian holding corporation holding an interest in an LLC that is considered a partnership in the United States may also be subject to withholding under IRC section 1446 on effectively connected income of the LLC (as income allocable to a foreign partner). If that income is considered FAPI in Canada, there will be no FTC in Canada because an FTC for FAPI is based on tax paid at the corporate level, not on tax withheld under section 1446. That will result in double taxation. If the LLC holds shares of a Canadian company, any income earned in Canada by the LLC will be subject to Canadian tax and may also be subject to a Canadian withholding tax if the income is paid to the LLC in the form of dividends. Accordingly, it may be prudent either to dissolve the LLC before immigrating to Canada if the LLC is a single-member LLC or convert it to a limited partnership.

An LLC or S corporation that elects to be treated as a disregarded entity in the United States may expose its unit holders or shareholders to withholding tax in the United States under IRC section 1446. That section imposes withholding tax on the ECI of a partnership for a tax year if any portion of the income is allocable to a foreign partner — that is, a partner who is not a U.S. person. Because a U.S. person is defined to mean a citizen of the United States, section 1446 should not apply to a U.S. citizen resident in Canada because that person will continue to be a U.S. person (by virtue of U.S. citizenship) and hence will not be a foreign partner. Also, section 1446 does not apply to single-member LLCs because those entities will not qualify as partnerships for U.S. tax purposes.

A U.S. citizen-Canadian resident should ideally not invest in Canada through a subchapter S corporation, which is an ordinary U.S. corporation that makes an election to be taxed under subchapter S of the IRC. When the election is made, an S corporation is treated as a flow-through entity for U.S. tax purposes, and its income will be taxed in the hands of its shareholders. The election to be an S corporation must be made by the corporation's shareholders, and the corporation must meet specific conditions to be eligible for S treatment.

An S corporation is a corporation under U.S. corporate law and is treated as a corporation for Canadian tax purposes. It is also entitled to the benefits of the Canada-U.S. tax treaty. The Canadian tax authorities believe that an S corporation is liable to tax in the United States under Article IV (residence) of the Canada-U.S. tax treaty and that using an S corporation for tax avoidance purposes is unlikely because of the regime's unique requirements (for example, shareholders must be individuals who are U.S. citizens, residents, or trusts with U.S. citizen or resident beneficiaries).[4] Moreover, it is liable by default to taxation in the United States on its worldwide income as a regular corporation and is treated as a flow-through entity only by reason of an election. Therefore, Canada extends the benefits of the Canada-U.S. treaty to S corporations.

If a U.S. citizen immigrates to Canada with an S corporation, there may be timing mismatches on taxation because Canada will tax the corporation, whereas the United States will tax the citizen. However, under Article XXIX(5) of the Canada-U.S. treaty, the individual may request that the Canadian competent authority deem the S corporation a controlled foreign affiliate of the person and deem all its income FAPI. As a result, the timing mismatch between the imposition of Canadian tax on the income of the S corporation (when it is distributed to the U.S. citizen-Canadian resident) and the imposition of U.S. tax on that income in the hands of the S corporation shareholders (when the income is earned by the S corporation) would be removed, thereby allowing relief from double taxation.

Further, if a Canadian resident is the sole director of a U.S. corporation or otherwise manages and controls that corporation from Canada (whether an S corporation, an LLC, or an ordinary corporation), the corporation will be deemed a resident of Canada as a result of its central management and control being in Canada. The corporation may, however, be able to rely on Article IV(3)(a) of the Canada-U.S. treaty to relieve itself from deemed Canadian residency because it was created under the laws of the United States.

Principal Residence Exemption

Canada exempts gains from the sale of a principal residence from tax in Canada if specific conditions are met. Canadian residents may not deduct the interest on the purchase of a residence but are not taxable on the profit on resale.

Although no Canadian tax arises on the sale of a principal residence in Canada, U.S. citizens can generally exclude up to US $250,000 (US $500,000 for married individuals) of the gain on the sale of a principal residence from U.S. income tax. Thus, a U.S. citizen who is single or is married to a Canadian citizen may be exempt from U.S. tax on US $250,000 of the gain. A U.S. citizen married to a U.S. citizen or green card holder and filing a joint return for a tax year may be exempt from U.S. tax on US $500,000 of the gain under specific circumstances. If required holding periods have been met, the balance of the gain is subject to U.S. tax at long-term capital gains rates. For U.S. purposes, the interest on the Canadian residence may be deducted within prescribed limits.

On the exchange of property, a U.S. citizen may be subject to the U.S. replacement property rules in IRC section 1031 to ensure that no gain or loss is recognized on the exchange of property held for

[4] CRA, "LLC — Status for Canada-U.S. Income Tax Treaty," Doc. No. 9713120 (May 20, 1997).

productive use in a trade or business or for investment if the property is exchanged solely for like-kind property to be held either for productive use in a trade or business or for investment.

Canada has more restrictive replacement property rules: The replacement property must replace a former business property and be in Canada.

A U.S. citizen resident in Canada who takes advantage of the U.S. replacement property rules may realize a taxable disposition in Canada.

Planning Considerations

Several planning considerations must be considered by prospective immigrants or newcomers to Canada. Some of the more relevant ones are shown below.

General

On becoming a resident of Canada, an individual benefits from an increase in tax cost for assets owned outside Canada. The cost will be equal to the assets' FMV on the date the individual becomes resident in Canada. Canada will not tax the gain that accrued before moving to Canada. Valuations are recommended. If an individual ceases to be a Canadian resident within five years, there is no Canadian departure tax on assets outside Canada owned when the person became a Canadian resident.

A Canadian resident is taxable in Canada on worldwide income. If tax is paid on income in another jurisdiction, an FTC should be available in Canada up to the rate of Canadian tax. The top personal rate in Ontario is 54 percent for ordinary income, capital gains are taxed at approximately 27 percent, and dividends received from a Canadian company are taxed at approximately 44 percent. There are no joint returns or wealth taxes in Canada. If the individual directly owns real estate outside Canada, the income will be computed under Canadian tax rules.

If the individual owns more than 10 percent of a foreign company carrying on an active business, the active business income may benefit from a lower corporate rate if the foreign company is resident and the income would not be attributed to a Canadian shareholder. Also, dividends paid to a Canadian holding company out of active business earnings of a foreign affiliate are exempt surplus and not taxable to the Canadian corporate parent. A foreign real estate company will be active only if it has more than five full-time employees. Canada will not tax the income because it is earned by an active business (assuming the foreign company is managed and controlled outside Canada). It is advantageous to form a Canadian holding company to own those shares because dividends paid out of active business income (exempt surplus) may be received by a Canadian holding company free of Canadian tax. If the dividend is received out of exempt surplus, tax is deferred in Canada until the individual takes funds out of the Canadian holding company. There is no FTC for any foreign withholding tax on dividends. A dividend received personally by an individual from a foreign company is taxed at 54 percent. However, if the individual plans on ceasing Canadian residency on obtaining Canadian citizenship, it might not be advantageous to interpose a Canadian holding company that would not be tax efficient once the taxpayer ceases to be resident in Canada.

If a foreign company is not Canadian controlled and earns passive income, the individual Canadian resident shareholder will be taxed on an attribution basis under FAPI rules when the income is earned with credit for foreign taxes. The tax cost of the shares of the foreign company is increased by the income inclusion. If the company is Canadian controlled, it will be deemed resident in Canada (unless a treaty deems it resident where it is incorporated) and taxable in Canada on its worldwide income. Consideration should be given to resigning as director of non-Canadian companies and trustee of non-Canadian trusts before immigration to Canada.

Investments in offshore funds are taxable in Canada. The legal structure of each fund will determine the tax treatment — the fund may be a partnership or exempt company or a trust or a special entity. As indicated above, if the fund is a corporation and the investment was not motivated to save Canadian tax, the imputed return may be avoided under the offshore investment fund property rule.

There may be techniques to facilitate a tax-free return of capital to the individual from the offshore company. For example, the individual may declare a dividend before immigrating to

Canada. The dividend ideally would not be taxed at all or taxed at a lower rate where the individual resides than it would in Canada. The dividend could be satisfied by a promissory note. Alternatively, before moving to Canada, the individual may increase the paid-up capital of the foreign corporation if permitted by the applicable foreign corporation. The individual may also sell assets or shares to a nonresident before immigration and take back a note. The gain would be realized before becoming a resident of Canada and would not be taxable in Canada. In each case the repayments of the notes, after the person becomes a resident in Canada, would be tax free in Canada. Any interest on the notes would be taxable in Canada.

In some cases, a foreign company holding passive investments should be dissolved pre-immigration. As indicated, there is a step-up in tax cost for assets directly owned by the individual. It is preferable to step up the tax cost of the passive investments (for example, a portfolio of securities) rather than the shares of a holding company because tax will be paid in Canada when a foreign holding company sells passive assets without a step-up in tax cost. By liquidating the holding company before moving to Canada, it is possible to step up the tax cost of each asset owned by the holding company.

A redemption or purchase of cancellation of shares the individual personally owns in a non-Canadian company for an amount not exceeding the FMV when he became a Canadian resident will not be taxable in Canada.

When possible, exercise employee stock options granted as a nonresident before immigrating to Canada.

Foreign Companies — Tips and Traps

Avoid being the sole director or managing and controlling the company from Canada, if possible. Otherwise, ensure that the company can rely on a Canadian tax treaty to avoid being deemed a resident of Canada based on central management and control. For example, a U.S. C corporation is deemed resident when incorporated under the relevant treaty.

Avoid creating a Canadian branch for the corporation by using the immigrant's Canadian address as the corporation's Canadian location. Ensure the presence of the immigrant does not lead to a permanent establishment in Canada for the corporation. A PE may result if the corporation has an office or place of management in Canada or if it has employees or dependent agents concluding contracts in Canada.

Understand how foreign corporations are taxed in Canada. Avoid FAPI characterization if possible.

Avoid owning LLC units if possible. Avoid timing mismatches in S corporation holdings by electing to treat all income as FAPI.

Trusts

Understand the application of the nonresident trust rules and their applicability to any offshore trusts in which the immigrant may be a contributor or beneficiary.

Avoid having the trust deemed resident in Canada because the trustee becomes a resident of Canada or because its central management and control is in Canada (always avoid being the sole trustee of a foreign trust).

Set up foreign trusts in a manner that ensures that the contributor is nonresident. For example, nonresident parents may settle an *inter vivos* or testamentary trust for a Canadian using non-Canadian assets. Consider tax-efficient distributions from those trusts.

Personal Planning

Consider the date of entry into Canada and implement planning steps before.

Consider wills and powers of attorney. For example, to ensure that a trust is discretionary, the will of the nonresident parents of a taxpayer immigrating to Canada should be changed before immigration to ensure that payments are discretionary and that only capital distributions will be made to a Canadian resident beneficiary.

For taxpayers working offshore, consider if offshore employment may delay Canadian residency for tax purposes. Spouses and children may move to Canada, although the CRA might view that as an indicator of Canadian residency.

Create Canadian wills and powers of attorney for immigrants.

For taxpayers moving from the United States, consider gift and estate tax issues and the unique tax treatment of the United States for its citizens in conjunction with the tax regime in Canada. ■