TAX FLASH

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MITIGATING U.S. TAX EXPOSURE THROUGH THE CLOSER CONNECTION STATEMENT

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Canadian persons that spend significant time in the United States can become subject to U.S. taxation and reporting requirements unexpectedly, even if they are not earning income from U.S. sources. Starting June 30th, 2014, a new initiative will begin that is designed to track a Canadian person's movement across the Canada/U.S. border. Prior to this new initiative, many Canadian persons felt, perhaps justifiably, that U.S. authorities had no way of actually knowing how many days they were present within their border. This was largely because though both Canada and the U.S. had tracked the day a person enters the country, they hadn't tracked the departure date and even more, neither country typically shared this information with the other.

A new cooperative effort is being implemented entitled the "Entry/Exit Initiative of the Perimeter Security and Economic Competitiveness Action Plan" and takes effect June 30th, 2014. Essentially, this program provides that both Canada and the U.S. will begin sharing information as to when people enter and leave their respective countries. Because the implications of surpassing the number of days allowed in the U.S. can be quite significant and due to the new information sharing effort between the U.S. and Canada as per the above, it is important for Canadians to understand the rules surrounding the determination of U.S. status and the associated tax and reporting requirements.

Under IRS rules, if a Canadian person spends greater than 182 days within a calendar year, he/she risks being considered a "U.S. Person" for tax purposes – a status effectively the same as any U.S. Citizen or green card holder. Note that the manner in which the 182 day limit is determined is not as straightforward as simply counting the number of days spent within the U.S. during a tax year. The IRS requires a complicated calculation that looks at the current year and the two preceding years. Generally, to compute the number of days spent in the U.S. during 2013, every day spent in the U.S. between January 1, 2013 and December 31, 2013 is considered "one" day. To that total, you must add one third of every day spent in the U.S. during 2012 and one sixth of every day spent in 2011. If this calculation exceeds 182 days, a non-U.S. individual could be considered a U.S. Person. As a general rule of thumb, if a Canadian stays in the U.S. for greater than 120 days year over year, such person runs the risk of exceeding the 182 day requirement using the calculation described above.

Being considered a U.S. Person could have potentially damaging tax effects on a Canadian. For one, a U.S. Person is taxed on worldwide income and thus, is required to file a U.S. income tax return, reporting worldwide income from all sources on such return. Although a foreign tax credit is generally available for Canadian taxes paid on the worldwide income included in this return, there are additional U.S. taxes – the new "Obamacare" tax for example – and potential U.S. income inclusions not reflected for Canadian tax purposes that could create a mismatch and subject a Canadian to out of pocket U.S. tax. Even more, certain U.S. reporting forms are required to be filed by U.S. Persons – the oft mentioned "FBAR" form for example – and submitting these forms late can attract significant penalties. In many cases, these penalties can amount to $10,000 per instance of non-filing per year and can add up very quickly, particularly if there is more than one taxation year involved. Furthermore, the compliance costs and complicated rules associated with meeting U.S. tax reporting obligations can be very overwhelming and problematic.

The good news is that a Canadian who exceeds the 182 day requirement can take a position that despite the amount of time spent, he/she still has a "closer connection" to Canada and should not be considered a U.S. Person. Those able to take this position should not be subject to the U.S. income tax and U.S. information reporting obligations described above. To make such an assertion a Canadian should file Form 8840 with the IRS, claiming that certain factors, which indicate closer economic and personal interests, lie with Canada as opposed to the U.S. The form is not overly lengthy – two pages – but importantly, it needs to be **filed with the IRS by June 15th** of the year following the applicable tax year. To be effective for the 2013 tax year, Form 8840 needs to be filed by **June 15th, 2014.**

As the U.S. is becoming more and more focused on compliance and reporting, it is essential that Canadians pay strict attention to the processes available to mitigate U.S. tax and penalty exposure. Where determination of U.S. Person status is concerned, we recommend that those approaching the 120 days per year guideline, and that are able to make such a claim, file the 8840 closer connection form by the due date to manage the issue. We would be pleased to assist with the preparation of this filing and look forward to hearing from any and all interested parties.