

# Snowbirds beware!

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*For Canadian residents spending time in the United States (“US”), it is important to ensure that the heat you receive next time you venture south is only felt from the sun, and not the Internal Revenue Service (“IRS”).*

Each year thousands of Canadians make the trek to warmer climates in an attempt to avoid Canada’s long, cold winter months. More often than not, these winter retreats take Canadians to the US. Whether your passion is Florida, Arizona or some other favourite southern state, such a retreat may not only put you closer to the sun, but closer to the IRS.

Depending upon the duration of your stay in the US, you may be classified as a US resident for income tax purposes and be required to complete certain tax filings. Most Canadians who spend significant time in the US are required to file a US tax return or other filing in order to avoid paying US taxes on worldwide income.

## Determination of US tax residency

If you visit the US on a regular basis, there are three categories into which you may fall:

1. **Present in the US for 183 days or more in the current tax year.** Pursuant to the provisions of the Internal Revenue Code (“IRC” or the “Code”), if you are present in the US for 183 days or more in the current tax year, you will automatically be classified as a US resident and may be required to file a US tax return (Form 1040) in order to report your worldwide income in the US. You may be able to claim a treaty tie breaker under the Canada-US income tax treaty in order to file a non-resident return (Form 1040NR).
2. **Present in the US for greater than 31 days, but less than 183 days during the current year and you meet the Substantial Presence Test.** If this is the category into which you fall, you will be considered a resident alien and be required to file a Form 1040 in order to report your worldwide income in the US, unless you use the treaty-tie breaker rule or you can demonstrate a closer connection to Canada than to the US (see discussion below under the heading “Substantial Presence Test”).
3. **Present in the US for less than 31 days during the current year or do not meet the Substantial Presence Test as set out in category two above.** If this is your situation, you will be categorized as a non-resident alien and not be required to file a US tax return unless you have certain US source income for which adequate withholdings have not been made or you are engaged in a US trade or business (including employment within the US).

## Substantial presence test

In order to determine who is a US resident, the US utilizes a formula which considers the days that an

individual is present in the US over a three year period. This formula is commonly known as the Substantial Presence Test. The test calculates the number of days actually spent in the US during the current year, plus the number of days spent in the US in the immediately preceding year multiplied by 1/3, plus the number of days spent in the US in the second preceding year multiplied by 1/6. If the calculation totals 183 days or more, the individual meets the substantial presence test and will be classified as a resident alien. It is important to note that for the purposes of this test, the days present in the US need not be consecutive. You will be considered to have been present in the US on any day that you were physically in the US, whether you are present for the entire day or only part of the day.

The following example demonstrates the effect of the above formula. Mr. and Mrs. Sunshine are residents of Canada and have a winter home in Florida. For the past several years Mr. and Mrs. Sunshine have spent a portion of the winter months in Florida and also some time in the US during other parts of the year.

In 2008, Mr. and Mrs. Sunshine spent 3 months (91 days) in Florida during the winter and an additional 3 weeks (21 days) in the summer. In 2009, Mr. and Mrs. Sunshine spent 4 months (122 days) in Florida during the winter and a further 2 weeks (14 days) in May. In 2010, Mr. and Mrs. Sunshine spent 6 weeks (42 days) traveling in the US and another 11 weeks (77 days) at their home in Florida.

Based on the above, the “substantial presence” test would be applied as follows:

Years	# of days in US	Multiplier	Formula Days
2008	112	1/6	18.66
2009	136	1/3	45.33
2010	119	1	<u>119.00</u>
			183.00

Mr. and Mrs. Sunshine will therefore be deemed to have been in the US for 183 days during the current year and will meet the Substantial Presence Test. Although this will effectively result in their being classified as resident aliens, they may be able to use an exception to avoid being liable for US income taxes on their worldwide income.

In order to avoid the requirement to file a US 1040 tax return, Mr. and Mrs. Sunshine will each be required to complete and file a “Closer Connection Exception Statement For Aliens” (Form 8840). They must provide evidence to the IRS that they have a closer connection to Canada than to the US in order to escape US taxation. In the event that Form 8840 is not filed on time (June 15, 2011 for the 2010 tax year), Mr. and Mrs. Sunshine would be estopped from claiming a closer connection to Canada, which could result in US taxation of their worldwide income.

You will be considered to have a closer connection to Canada if you can demonstrate that your economic and social ties to Canada are more significant than are your economic and social ties to the US. The following are some of the indicia that the IRS considers in determining the “closer connection”:

1. location of permanent home(s);
2. location of personal belongings (ie. cars, furnishings);
3. location of banking relationships and investments;
4. location of drivers licenses;
5. countries from which you derive the majority of your income; and
6. business and personal ties.

If you have applied for or been granted a “green card” you will not be permitted to claim a closer connection to Canada.

If you are successful in establishing a closer connection to Canada by timely filing a Form 8840, you avoid the necessity of filing a US resident tax return and possibly incurring double taxation.

## **Residence under the Canada-United States income tax convention**

Generally, if an individual fails to file a Form 8840 on time, the individual will be considered a US resident for tax purposes and be required to pay US income tax on his or her worldwide income. Nonetheless, it may still be possible for the individual to have his or her residency status determined under Article IV of the *Canada – United States Tax Convention* (the “Treaty”).

The main purpose of the Treaty is to reduce the potential of an individual being taxed twice on the same income. The treaty attempts to resolve the issue where an individual is deemed to be a resident in both the US and Canada. You may be classified as a non-resident alien under Article IV for the purposes of calculating your US income tax liability if the following conditions are met:

1. you are deemed to be a resident of both the US and Canada pursuant to each country’s respective tax laws; and
2. your permanent home is in Canada and your personal and economic ties are closer to Canada than to the US.

Although relying on the Treaty may permit you to escape US taxation as a resident on worldwide income, you will still be required to file a US Form 1040NR with a “Treaty-Based Return Position Disclosure under Section 6114 or 7701(b)” (Form 8833). These filings are far more complicated (and thus more expensive to have prepared) and intrusive than a Closer Connection Exception Statement, so most clients prefer to file a Closer Connection Exception Statement if at all possible.

## **Conclusion**

If you are among the thousands of Canadians returning to Canada after a long cold winter, you may want to consider your potential US tax liability and filing requirements before it is too late. If you are a Canadian who spends significant time in the US, it is imperative that you obtain professional advice to determine the extent of your tax filing and tax payment obligations. We expect that the IRS’s increased scrutiny of taxpayers with foreign connections, combined with increasing use of technology, will cause the IRS to pay closer attention to those that are not filing required US forms and returns.

*The foregoing information is provided for general informational purposes only and readers are*

*encouraged to consult with their professional advisors as to their specific circumstances.*

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