Americans Exiting Canada: **Understanding the Five-Year Deemed Disposition Rule**

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American citizens living in Canada for more than five years face an imposed exit tax on unrealized gains.

One of the most common questions we receive from Americans moving to Canada is how to navigate around the Canada Revenue Agency's five-year deemed disposition rule. Canada assesses an exit tax on any unrealized capital gains inside taxable accounts in cases where the U.S. citizen moves back to the United States after having been a Canadian tax resident for longer than 60 months.

It is important to note that this rule does not apply to any tax-deferred investment accounts or plans.

Some visa holders arrange their date of return to the United States to be 60 months less a day in order to avoid qualifying for this event. But in many cases, this is inconvenient for the corporations that employ them. And it can create personal family hardship, should it occur, for example, in the middle of a school year.

The Canada-U.S. tax treaty requires that non-tax-deferred securities accounts be taxed in the country of the beneficial owner's residency. Accounts that are transferred to Canada from the United States "in kind" retain their original cost basis (usually the purchase price) for U.S. tax purposes. But a second cost basis—equal to the accounts' market value on the day the beneficial owner became a Canadian resident for tax purposes—is automatically generated. This can cause confusion, and in many cases erroneous tax reporting, in both Canada and the United States.

Does leaving your accounts in the U.S. help?

In the past, some U.S. citizens would simply leave their U.S. taxable and trust accounts in the United States in an attempt to get around the Canadian five-year tax rule. Prior to 2013, this sometimes worked. The CRA required, but did not rigorously enforce, reporting of unrealized capital gains of all taxable accounts, including those remaining in the U.S.

The CRA T1135 form requires a detailed accounting of a Canadian taxpayer's interest in a foreign bank, investment, corporate, trust, and investment real property assets. If the value of the accounts is greater than $100,000 CAD, it must be reported along with any investment or capital gain/losses realized for the tax year. Interests in foreign personal-use real property or retirement accounts are not required to be included on the T1135.

Failing to file this form leads to penalties. And given the increased information sharing initiatives now in place between the CRA and IRS, taxpayers must be compliant. If an American moves back to the United States after five years, the CRA will have a complete record of all of their taxable investment accounts in both countries. When completing the Canadian exit tax returns, you will be assessed on any unrealized capital gains from the date of when you entered Canada to the date of departure. This is reported on your Canadian exit return through Forms T1161 and T1243.

How do the tax rules work?

- Let's use a hypothetical example to illustrate how the rules work. For simplicity's sake, we will ignore currency exchange. Bear in mind that in real life, currency exchange must be accounted for to determine the proper Canadian basis and ultimate proceed numbers for Canadian and U.S. purposes.

- You purchase a number of investment securities (stocks, bonds ETFs etc.)in a taxable account that has a U.S. cost basis of $50,000. When you later move to Canada, the account is worth $100,000 ($50,000 of which is unrealized gains). Regardless of where the account is domiciled (Canada or the United States), you now have two adjusted cost bases for tax purposes. The U.S. basis is $50,000. The Canadian basis is $100,000.

- Five years later, you move back to the United States; the account has now grown to a value of $150,000 ($100,000 capital gains for U.S. tax purposes and $50,000 for Canadian tax purposes). For Canadian tax purposes, you will have an imposed departure gain of $50,000. In Canada, 50% of the gain is taxable at your respective marginal rate. Assuming that you are in the highest marginal rate in Ontario upon exit, your net tax would be 26.76%.

For U.S. tax purposes, you would have to pick up capital gains of $100,000.

The current U.S. long-term capital gains rate of 15% would be applied. However, depending on your filing status and U.S. Adjusted Gross Income amounts, you could be subject to an additional 5% capital gains tax and a 3.8% levy on all net investment income for the tax year. Therefore, it is extremely important to proactively gain a sense of what exposure might exist in Canada and the United States prior to departure or the end of the tax year in order to avoid any unnecessary surprises.

- On any Canadian tax paid, you would receive a passive foreign tax credit. The credit may be used for U.S. tax reporting purposes under the Canada-U.S. tax treaty—provided that it is properly filed by your accountant. It should be noted that this is a "deemed" sale, and not an actual sale of the securities in the account. For U.S. tax purposes, your original adjusted cost basis is still $50,000.
- Interestingly, when moving back to the United States, the IRS does not allow for a stepped-up basis to be used for securities bought while living in Canada. Unlike in Canada, where the basis for Canadian tax purposes is calculated based on the market value on the day that the beneficial owner became a Canadian resident for tax purposes, the U.S. will only recognize the original basis. This means that if a security was bought in Canada for $50,000 and it was valued at $100,000 at the time you move back to the U.S., the IRS would consider $50,000 to be the cost basis—it will not allow it to be stepped up to $100,000.

How to minimize the Canadian exit tax

A qualified Canada-U.S. cross-border financial advisor will keep track of both your Canadian and U.S. cost bases, and tax-manage your portfolio accordingly. Actively and prudently employing tax-loss harvesting to offset gains can reduce the amount of exit tax owed. Contact Cardinal Point to learn more about our tax-managed portfolio strategies for Americans living in Canada, and how we personalize our investment process to fit your needs.

Contact Cardinal Point for more information

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