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CROSS-BORDER WEALTH MANAGEMENT

RESIDENTS OF CANADA

What are the Canadian and U.S. Tax Ramifications when being forced to liquidate a U.S. brokerage account

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As noted by several articles that have been published, many banks and brokerage firms, including Wells Fargo, Morgan Stanley, Fidelity, and others, are informing U.S. non-resident clients that they are no longer able to service their accounts and that their accounts have been restricted or even closed. In this case, the term "non-resident" is not based on the U.S. income or estate tax definitions, but loosely refers to the location of the principal or primary residence. This means that U.S. citizens and Green Card holders who reside in Canada or anywhere else abroad would be considered to be non-residents for the purposes of these regulations. These regulations are not new, but were not generally monitored or enforced. However, with the passage of the Foreign Accounts Tax Compliance Act (FACTA) in 2010 and the accompanying reporting requirements of that law, financial institutions also began enforcing those older regulations. More information about FACTA and why these restrictions are being enforced can be found in our article.

The options available to an individual once they have received notification that they are required to find another service provider depend upon whether the account is a tax-deferred account (such as an IRA or 401K), or a taxable brokerage account. Options for tax deferred accounts will be addressed in a separate article and we will focus only on taxable brokerage accounts here. For those accounts, the account holder will generally be told that if they are not able to transfer assets to another service provider within a set period of time, the assets will be sold. Once the assets are sold, the account holder would receive a check for the proceeds of the sale. In many cases, it is not possible to find an alternate service provider that allows a non-resident to maintain a brokerage account in the U.S.

Even if a new service provider can be found, it is likely that not all of the assets in a U.S. brokerage account can be transferred to a Canadian or other foreign brokerage account. For example, U.S. mutual funds cannot be held in a Canadian brokerage account. Because of these complications, many individuals are forced to liquidate either their entire U.S. brokerage account, or a sizeable portion.

Liquidating any part of a taxable brokerage account usually brings with it tax implications. For Canadian tax residents who are not also U.S. tax residents, this liquidation would only have Canadian tax implications, but for U.S. citizens who are also Canadian tax residents, a liquidation would have tax implications in both the U.S. and Canada.

We can illustrate the tax implications by examining these three scenarios.

- A U.S. citizen owning a U.S. brokerage account could move to Canada and become a tax resident of Canada.
- A Canadian citizen who lived in the U.S. for a period of time on a work permit, and who now owns a U.S. brokerage account as a result, could move back to Canada and once again become a Canadian tax resident.
- A U.S. citizen has been a long-term resident of Canada and has been a Canadian tax resident the entire period of ownership of U.S. brokerage accounts.

We will discuss each of these three scenarios separately, since the Canadian and U.S. tax implications of the sale of the assets contained within the brokerage account will be different for each scenario.

U.S. Citizen Becomes a Tax Resident of Canada

When you establish income tax residency in Canada, for Canadian income tax purposes, you are deemed to have disposed of all of your property immediately beforehand, with some exceptions, for proceeds equal to the fair market value of that property at that time. You are then deemed to have acquired such property at a cost equal to such fair market value. In effect, at the date of establishing Canadian residency, you would be entitled to a "step-up" in the Canadian tax cost of all property (with some exceptions) owned by you for the purposes of determining the capital gain or tax loss implications upon a future sale, the settling of a trust, or at death. To summarize, the assets contained within the U.S. brokerage account would have a Canadian cost basis equal to their fair market value on the date that you became a Canadian tax resident. For U.S. tax purposes, the assets would retain their historical cost basis. As such, the cost basis of the assets owned on immigration to Canada would be different for Canadian and U.S. income tax purposes.

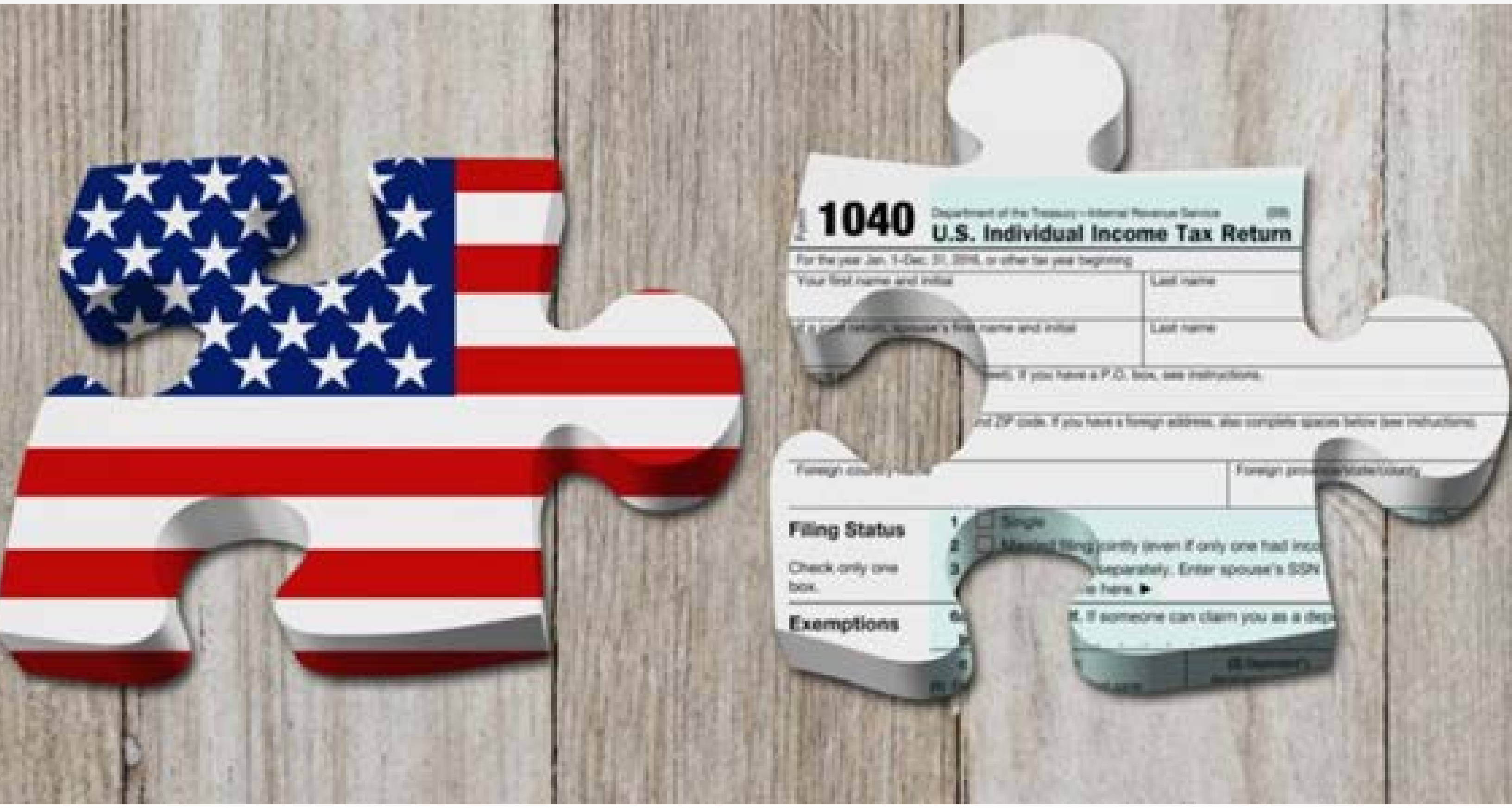
Canada taxes 50% of the realized gain as income, and the marginal tax rate would depend upon the province of residency. For example, a resident of Ontario would currently have a maximum rate of 53.53%. Since Canada taxes only 50% of the gain, that is the same as a 26.76% tax on the entire gain, and we will use this method when calculating taxes below. As mentioned above, only the growth since the move to Canada would be taxed.

The U.S. capital gains rate depends on how long the investment has been held and how much income has been earned. For investments held one year or less, capital gains are taxed as ordinary income. For investments held greater than one year, rates range from 0% to 20%. A 3.8% Medicare surtax is levied on investment income when AGI exceeds certain thresholds, so the maximum U.S. rate on long-term capital gains is 23.8%. The U.S. does allow for a foreign tax credit for the Canadian tax payable on the capital gains, however, the 3.8% Medicare Surtax is calculated after foreign tax credits, so will not be eliminated.

For example, assume that an Ontario resident has income from various sources that would put her in the top tax brackets in both countries. Let's also assume that the U.S. brokerage account contained long-term securities with a historical cost basis of $500,000. The securities were worth $750,000 upon immigration to Canada, and were worth $1,000,000 when she was required to liquidate the account. Let's also assume that the U.S. dollar was at par when the assets were originally purchased, was worth 1.15 Canadian dollars on immigration, and that the exchange rate at liquidation was 1.3. In this situation, the Canadian tax on the disposition would be (($1,000,000 * 1.3) less ($750,000*1.15)) multiplied by 26.76%. This comes to a Canadian income tax liability of CAD $117,075. Converted to U.S. dollars (at 1.3), this would equate to USD $90,058.

The U.S. income tax on the transaction would simply be 23.8% of the difference between $1,000,000 and $500,000, which comes to USD $119,000. The foreign tax credit from the Canadian taxes would eliminate USD $90,058, leaving a final U.S. tax liability of USD $28,942.

In this scenario, because of the bump-up in cost basis that limits the amount of Canadian tax paid, the overall tax rate upon liquidation is essentially equal to the U.S. tax rate. This scenario only covers assets that were owned upon immigration. Any assets purchased after immigration would be treated differently and will be dealt with in the third scenario.



Canadian Citizen Resumes Canadian Tax Residency

The second scenario is of a Canadian citizen previously living in the U.S. who moves back to Canada and resumes Canadian tax residency. In this case there would also be a deemed acquisition in the same manner as discussed above. Assets contained within the U.S. brokerage account would have a Canadian cost basis equal to their fair market value on the date the account owner became a Canadian tax resident.

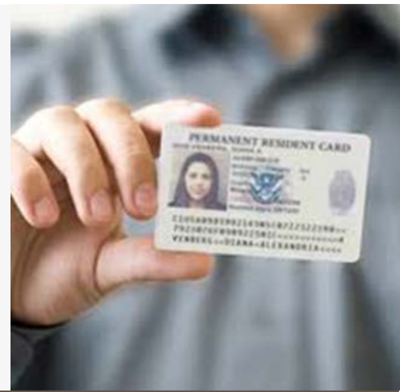
This article will not go into details of the rules for U.S. income tax residency, but for the purposes of this discussion, we will assume that U.S. tax residency will terminate on the same date that Canadian income tax residency began. This should be possible through the application of either the Closer Connection exemption, or through the application of the income tax treaty that is in place between Canada and the U.S. Since the U.S. does not tax non-citizen non-residents of the U.S. on the sale of stocks, mutual funds, and EFTs found in taxable brokerage accounts, the liquidation of the U.S. brokerage account will not be taxable in the U.S.

Using the same assumption from the first scenario, the Canadian income tax liability associated with the disposition would be CAD $117,075. Converted to U.S. dollars (at 1.3), this would equate to USD $90,058.

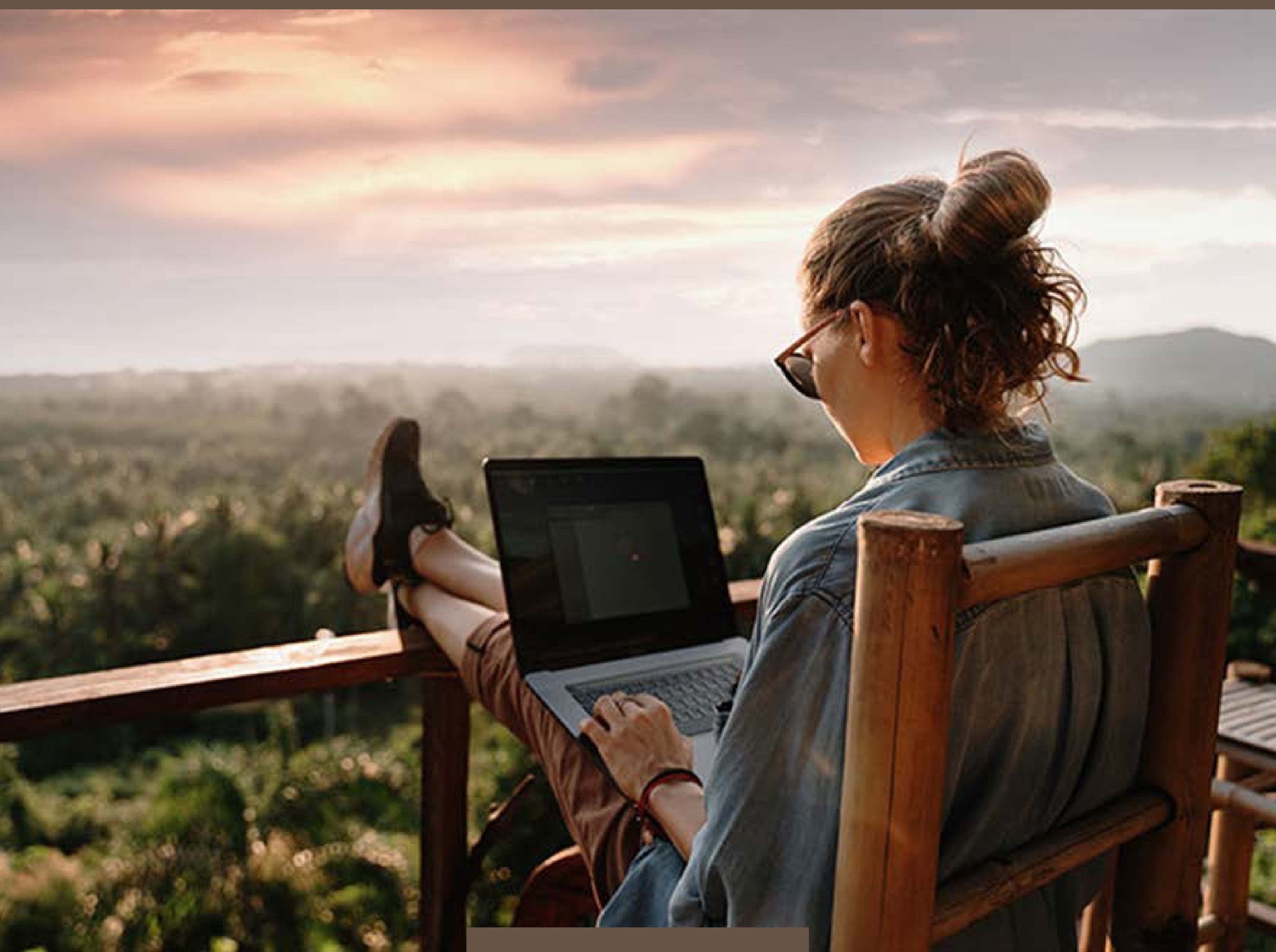
Since the individual is no longer a tax resident of the U.S., the disposition will not be taxable in the U.S. As such, in this scenario, the individual will avoid paying the additional USD $28,942 associated with the U.S. taxation of the account.

This highlights a planning consideration for Canadians who are not U.S. citizens or Green Card holders who plan on repatriating back to Canada from the U.S.

If they have assets in taxable brokerage accounts with unrealized gains, they should generally wait to liquidate these assets until after they have become U.S. non-residents. By doing so, they will pay little to no Canadian tax due to the bump-up in Canadian cost basis that they will receive, and the disposition will no longer be taxable in the U.S.



By extension, some Green Card holders may consider whether the benefits of expatriating and subsequently selling their assets as a non-resident of the U.S. outweigh the costs of losing Green Card status. A full discussion of the tax implications of expatriation is outside the scope of this memo, and undertaking any actions that could result in expatriation should not be pursued without discussing your unique facts and circumstances with tax and immigration professionals. However, for certain individuals, this represents an opportunity for significant tax savings.



U.S. Citizen as a Long-Term Tax Resident of Canada

In this case, since the U.S. brokerage account was opened while the individual was a tax resident of both countries, the bump-up in Canadian cost basis would not be applicable. The Canadian and U.S. cost basis would be the same, or similar. For the purposes of this discussion, we will ignore the differences in the calculation of cost basis when multiple units of the same stock are purchased over time (FIFO versus average cost etc.). Under these assumptions, the only significant difference in the two cost bases would be that the Canadian basis would be adjusted for the foreign exchange rate on the date of purchase.

For this scenario, let's also assume that the historical cost basis of the assets within the U.S. brokerage account was $500,000 and that the assets were worth $1,000,000 when account liquidation was required. Let's also assume that the U.S. dollar was at par when the assets were purchased and that the exchange rate upon liquidation was 1.3. In this situation, the Canadian tax on the disposition would be (($1,000,000 * 1.3) less $500,000 multiplied by 26.76%. This comes to a Canadian income tax liability of CAD $214,080. Converted to U.S. dollars (at 1.3), this would equate to USD $164,677.

The U.S. income tax on the transaction would remain 23.8% of the difference between $1,000,000 and $500,000, which comes to USD $119,000. The foreign tax credit from Canadian taxes would completely eliminate the regular U.S. income tax, but as mentioned above would not eliminate the 3.8% surtax. As such, a USD $19,000 tax liability would remain. The excess Canadian tax that was payable would be carried forward as a foreign tax credit carry-forward and can be used to reduce future U.S tax liability.

In contrast to the first scenario, where the cost basis bump up reduced the overall tax rate, in this case, the higher Canadian tax rates dominate and the overall rate would be even higher because of the 3.8% surtax.

This example highlights the difference in income tax rates between the two countries, but also highlights the significant impact that foreign exchange rates can have on the amount of tax that is payable. By being forced to liquidate the account when the U.S. rate was at 1.3, the Canadian capital gain that was realized was much larger than the gain that was realized in the U.S.

The Cardinal Point Advantage

These examples highlight how even a relatively simple concept such as the liquidation of an account can be more complicated than it initially appears. It is important to look at the situation from a tax perspective to ensure that the potential capital gain is properly calculated, and to determine whether any planning can be implemented to reduce the combined U.S./Canada tax liability. The last example also shows how variations in foreign exchange rates can significantly impact future tax liabilities.

Cardinal Point has the cross-border financial planning, investment management, and tax expertise to ensure that our clients are able to transition assets from one country to another in a tax-efficient manner.

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