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Leaving Canadian tax advantages behind

Non-resident shareholders may lose in many ways

Family business shareholders who leave Canada may trigger tax and legal issues in Canada and in their new country of residence. This bulletin gives you a brief overview of some potential problems.

Leaving Canada cancels many shareholder tax advantages

Many family businesses are incorporated and structured to qualify as Canadian Controlled Private Corporations (CCPC). Qualifying for this tax status means that the company may enjoy many benefits, including low corporate income tax rates if their activities generate ”active business income”.[1] But the company's status as a CCPC may be jeopardized if control of the company moves out of Canada.

For example, if the controlling shareholder[2] leaves Canada to become a non-resident, control of the company no longer rests with a Canadian resident and the company stops being a CCPC. Even if the shareholder doesn't own a majority of shares, they could still be treated as a controlling shareholder:[3]

- They have a contractual right to acquire shares that gives them control of the company (except through another individual's death, bankruptcy or permanent disability).
- They own a large block of shares, though not a majority. But they can routinely count on enough support from the remaining shareholders to control the company.

The Canada Revenue Agency (CRA) also asserts that a change of control away from Canada occurs when the residency of a trust changes.[4] A trust's residency is a question of fact, and depends on where the “central management and control of the trust actually takes place.” If the trustees only carry out administrative duties in response to orders from the beneficiaries, the trust will reside where the beneficiaries live. If multiple trustees in fact manage and control the trust, but live in different countries, “the trust will reside in the jurisdiction where the more substantial central management and control takes place.” Any change in residence by those who in fact control the trust may trigger a change in the trust's residence.

[1] See section 125(7) of the Income Tax Act (ITA).
[2] Having at least 50% of the voting shares of the company.
[3] See section 251(5) ITA.
[4] S6-F1-C1: Residence of a Trust or Estate

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An example

Consider the case of Dave, age 56. He's a Canadian citizen. He owns a controlling interest in Marvelous Marbles Inc., a highly successful business that manufactures ball bearings. Dave's wife died a few years ago. He has begun to transfer the day-to-day operations of Marvelous Marbles to his two nephews, Donald and John, so that he can spend more time relaxing, and, during the winters, enjoy more time at his condominium in Florida. While he's scaling back his day-to-day participation in the company, Dave still wants to maintain control over it.

While Dave was in Florida last winter, he met Susan, an American widow living in Orlando. This year they decided to get married and make Florida their home. To make sure he could spend as much time in the U.S. during the year as he wanted, and because he's now married to a U.S. citizen, Dave got his green card. He also applied to the CRA for a determination letter confirming that he is no longer a Canadian resident (and therefore no longer liable to pay Canadian taxes). He's now a lawful permanent resident of the United States, and pays taxes only to the Internal Revenue Service (Florida charges no personal state income tax). In a few years he'll even be eligible to become a U.S. citizen.

Unfortunately for Dave, his decision to become a permanent U.S. resident carries some unintended tax consequences for him and Marvelous Marbles. For Canadian income tax purposes he now becomes a non-resident, and loses the following tax benefits:

- Dave no longer benefits from the dividend tax credit on company dividends paid by Marvelous Marbles.
- He's no longer entitled to tax-free capital dividends from Marvelous Marbles' capital dividend account.
- He no longer benefits from the lifetime capital gains tax exemption ($813,600 for 2015, indexed annually to inflation).
- Dave was considering an estate freeze to freeze his capital gains liability in Marvelous Marbles, and to transfer future growth in the company to Donald and John. But that may not be as easy to carry out, now that Dave is a U.S. resident. The freeze requires Dave to give shares in Marvelous Marbles to Donald and John, which could trigger substantial gift tax liability for Dave.[5]
- Dave loses the tax deferral he currently enjoys on the exercise of his stock options. When Marvelous Marbles was incorporated, Dave had the company grant stock options to him. He exercised them a few years ago. As long as the shares are in a CCPC, Dave does not have to pay tax on the gain until he sells them, or until he dies. However, if the company loses its status as a CCPC, Dave will owe tax on the gain.
- For Canadian tax purposes Dave will be deemed to have disposed of his shares in Marvelous Marbles at fair market value (FMV) on the day that he ceases to be a resident of Canada. To the extent that he has a capital gain from the deemed disposition, half of that gain will be taxable under Canadian law at his top marginal rate. Dave must pay the tax when he files his final tax return with the CRA, or post security acceptable to the CRA. Under the Canada-U.S. Tax Treaty (the Treaty) and IRS Rev. Proc. 2010-19, Dave may elect to treat his shares as also having been disposed of under U.S. law. He may then claim a foreign tax credit on his U.S. tax return to partly or completely offset the Canadian tax paid on the deemed disposition. If Dave later sells his shares his adjusted cost base in those shares for U.S. tax purposes will equal the shares' fair market value on the day he ceased to be a Canadian resident.

He may also have to deal with the following additional tax issues:

- Under the Treaty, a 15% withholding tax applies on dividends that Marvelous Marbles pays to Dave (the normal withholding rate is 25%, and may be reduced by a tax treaty).[6]
- Dave becomes subject to U.S. estate, gift and generation skipping transfer tax, even if he moves back to Canada, for as long as he has his green card, and if he becomes a U.S. citizen.
- Any life insurance policies Dave owns will not be subject to Canada's exit tax, but there are other issues to consider regarding those policies:
    - 1% premium excise tax. Dave will have to pay a tax to the IRS on the premiums he pays for the policies.

[5] Dave could use the unified credit, available to U.S. citizens and permanent residents, to eliminate tax on gifts up to $5.43 million during his lifetime (2015 limit, indexed to inflation). However, any amount of the credit he uses to eliminate tax on gifts made during his lifetime will not be available for use at his death to reduce estate tax.

[6] Dave should be able to claim a foreign tax credit on his U.S. tax return to reduce or eliminate the withholding tax.

- Asset reporting requirements under the Foreign Bank Account Reporting (FBAR) and Financial Account Tax Compliance Act (FATCA) rules. Dave will have to report each policy as a foreign asset on two separate forms. There are severe penalties for failing to file.
- Inclusion of the death benefit as an asset in Dave's estate at his death for U.S. estate tax purposes if he owns the contract at death or owns it within three years of death. Dave should speak with a lawyer about transferring any life insurance policies he owns on his own life to an irrevocable life insurance trust.
- Annual testing of his Canadian life insurance policies to ensure that they still qualify as life insurance policies under U.S. rules. Canadian companies test their policies only for compliance with Canadian rules. The testing will have to be done by a third party actuary, not the life insurance company that issued the policy.

These tax consequences are bad enough, but there's more. Since Dave is a controlling shareholder of Marvelous Marbles, his non-resident status has an adverse impact on his company:

- Marvelous Marbles loses its small business deduction for up to $500,000 of qualifying income. Its tax rate rises from around 16% on its first $500,000 of qualifying income to around 30% (the actual rate depends on the province). Overnight Marvelous Marbles' income tax liability nearly doubles.
- Marvelous Marbles is a cutting edge researcher in the field of ball bearings. It loses its enhanced investment tax credits, which may be fully refundable, for its qualified expenditures on scientific research and experimental development.
- If Donald and John ever want to sell their shares in Marvelous Marbles, they could not take advantage of the lifetime capital gains exemption because Marvelous Marbles no longer qualifies as a qualified small business corporation (because its controlling shareholder, Dave, is a non-resident).

Dave loves Susan, and loves his new life in Florida. But for the foreseeable future, instead of relaxing, he'll be dealing with lawyers and accountants as he tries to straighten out his tax issues.

Advising clients

- Ask clients regularly about their residency, citizenship and domicile, and those of family members and beneficiaries.
- Expand your legal contacts to include legal centres of influence and resources in other jurisdictions.
- Recommend clients seek pre-emigration advice before making any moves to avoid or minimize problems from the move.

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Author: Stuart L. Dollar, M.A., LL.B., CFP, CLU, ChFC, Director Tax, Wealth & Insurance Planning Group

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