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US TAX ALERT

SNOWBIRDS AND THE CLOSER CONNECTION EXCEPTION

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Fall is the time of year when Canadian snowbirds pack up and head south for the warmer winter in the U.S. Some limit their stay to a maximum of 182 days, under the mistaken belief that this will avoid being considered a resident of the U.S. for income tax purposes (and conveniently brings them home just in time for spring). Many do not realize that the U.S. residency rules for income tax purposes involve a much shorter time period.

The U.S. tax rules contain a mathematical formula to determine tax residency. The formula involves counting the number of days you are present in the U.S. over a three-year period. This residency formula is called the Substantial Presence Test (SPT). Based on the SPT formula, if you exceed 182 days, you are deemed a resident of the U.S. for income tax purposes.

The SPT formula takes all of the days in the current year (i.e. the taxation year in question), 1/3 of the days in the previous year, and 1/6 of the days in the second previous year. You add up the result from this formula, and if you have been in the U.S. for at least 31 days in the current year, and at least 183 days based on the three-year formula, then you are deemed to be a U.S. resident for U.S. income tax purposes.

Consider this example: you were in the U.S. for 121 days in 2013, 125 days in 2012, and 136 days in 2010. The SPT calculation would be:

2013: 121 x 100% =	121 days
2012: 125 x 1/3 =	42 days
2011: 136 x 1/6 =	23 days
Total	186 days

Since you spent more than 31 days in the U.S. in 2013, and the SPT formula yielded a result that is at least 183 days (186 days, to be precise), you are considered a resident of the U.S. for tax purposes. As a general rule, if you regularly spend more than four months per year in the U.S., you are likely to meet the SPT and be considered a resident of the U.S. for tax purposes.

The Closer Connection Exception

The good news is that this is not the end of the story. If you meet the SPT but you were in the U.S. for less than 183 days *in the current year,* you may file a form with the Internal Revenue Service (IRS) to report that you have a closer connection to another country and are thus exempt from the U.S. residency designation. Form 8840, the Closer Connection Exception Statement for Aliens (yes, you are an alien to the IRS), is a simple, two-page form answering a number of questions about your residential ties in your "home" country (e.g. where you own a house, where you bank, where you vote).

You must complete this form and send it to the IRS each year. By doing so, you acknowledge that you meet the U.S. residency rules (the SPT), but you are taking advantage of the exception to these rules based on a closer connection to your home country. You also protect yourself from the IRS coming back at a later date and determining that you were a resident of the U.S. and seeking to tax you on your worldwide income. For most people, this form must be submitted to the IRS by June 15 of the year following the tax year in question.

The IRS does not have any penalty provisions for late filing this form. However, it is still important to file the form on time. If you met the SPT and did not file the Closer Connection Exception form, the IRS might determine you were a U.S. resident and request that you file U.S. tax returns.

Depending on your income level and the amount of tax you paid to Canada, you may be able to take a foreign tax credit on the U.S. return to reduce or eliminate any U.S. tax. With this in mind, if you have not filed the Closer Connection Exception form and you have passed the filing due date, you should consider

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being proactive and filing a U.S. non-resident alien tax return and attach a treaty statement indicating that, under the treaty between Canada and the U.S., you are not subject to U.S. tax. There is a $1,000 penalty for failing to disclose a treaty-based position, so being proactive is a good idea. The IRS is more likely to apply this penalty on a tax return that they are requesting than on one you have filed voluntarily. In addition, it is possible that border authorities could deny you entry to the U.S. if you have not filed the proper forms.

If you exceed 182 days in the U.S. *in the current year,* you will not qualify to use the Closer Connection Exception. However, in this situation you will still be able to file a "treaty-based return," as mentioned above. On a treaty-based U.S. tax return, you only pay tax in the U.S. on certain U.S. source income (and you exclude any income that is not earned in the U.S.). This is the case because the treaty between Canada and the U.S. provides that, if you are considered to be a resident of both Canada and the U.S., you can use residency "tie-breaker rules" contained within the treaty to make a conclusive determination of the country in which you should be resident for tax purposes.

The first of the tie-breaker tests looks at where you have a "permanent home" available to you. If you do not own or rent (on a long-term basis) a property in the U.S., and you have a permanent home in Canada, you are considered a resident of Canada and deemed to be a non-resident of the U.S.

If you do have a permanent home available to you in the U.S. and in Canada, the tie-breaker rules look at your "center of vital interests." Your center of vital interests is the country in which your personal and economic ties are closer, and focuses on such factors as the location of your immediate family, where you do your routine banking, where you work, and where your social and professional organizations are located.

If you cannot determine your center of vital interests, you then look to determine the country considered to be your "habitual abode." Roughly speaking, this is the country in which you spend most of your time. If you still cannot "break the tie" using this test, you look to the country of which you are a citizen. At the end of the day, you should only be considered a tax resident of one country.

If you meet the SPT, the easiest course of action is to file Form 8840. If you have not filed that form on time, you should consider filing a treaty-based return for the years in question. Don't make the mistake of thinking that not filing anything with the U.S. government will keep you off their radar. With improving border technology and increased interaction between border security and the IRS, it is likely just a matter of time before the U.S. authorities catch up with delinquent non-filers.

Filing the two-page Form 8840 annually is well worth the effort to protect against the risk of having the IRS come knocking on your door, or being banned from entering the U.S. The snow has already started to fly in parts of Canada. If you are a snowbird packing for your voyage south, remember the Closer Connection Exception form – the sunscreen you need to protect you from being burned by the IRS.

MANDATORY FBAR E-FILING

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The U.S. Foreign Bank and Financial Accounts form (FBAR) has garnered much attention in recent years due to the enormous potential penalties associated with filing the form late. The FBAR has also been a target of the IRS. In 2009, then Commissioner of the IRS, Douglas Shulman, stated, "If you are a U.S. individual holding overseas assets, you must report and pay your taxes or we will be increasingly focused on finding you."

For those not familiar with this filing requirement, U.S. citizens, residents and certain other U.S. persons must annually report their direct or indirect financial interest in, or signature authority over, a financial account that is maintained with a financial institution located in a foreign country (i.e. outside of the U.S.). This reporting is required if, for any calendar year, the aggregate value of all foreign accounts exceeded USD $10,000 at any time

during the year. The reporting is done on Form 114 (formerly Form TD F 90-22.1) and is often referred to as the "foreign bank account report," or FBAR. The FBAR must be received by the Department of Treasury on or before June 30 of the year following the calendar reporting year in question.

Generally speaking, in non-willful violation cases, a late-filing or failure-to-file penalty of up to $10,000 can be assessed *for each account.* In more severe cases of willful violation, civil penalties can reach the greater of $100,000 or 50% of the account value. Criminal penalties may also be assessed, with fines of $250,000 and up to five years in prison.

In our experience, most taxpayers are completely unaware of the FBAR filing requirements, and the IRS *generally* has allowed them to file delinquent FBAR forms (through various IRS programs) without having any penalties imposed. However, as recently as January 2013, the IRS and the Department of Justice penalized a 79-year-old woman over $21 million plus prison time for failing to report the income earned from Swiss bank accounts, and failing to disclose the accounts themselves on an FBAR form. The sentencing judge ultimately showed compassion for the elderly woman, who paid the $21 million penalty; he did not sentence her to any jail time but instead sentenced her to *five seconds* of probation.

E-filing requirement and changes

The Financial Crimes Enforcement Network (FinCEN), the government body responsible for the administration of the FBAR, implemented a substantial change in the FBAR filing process by imposing mandatory e-filing as of July 1, 2013. FinCEN developed an electronic filing system that accepted electronic FBAR forms in 2011, but the e-filing was not mandated until very recently. FinCEN claims that e-filing the form is quicker, more secure, free, and provides an instant confirmation of successful filing. FinCEN also threatens a $500 civil penalty for filing a paper form rather than e-filing.

The FBAR form is prepared and e-filed using the BSA (*Bank Secrecy Act*) e-filing website at http://bsaefiling.fincen.treas.gov/main.html. Attorneys, CPAs, and enrolled agents are permitted to prepare and e-file the form on behalf of taxpayers. A "Record of Authorization to Electronically File FBARs" (Form 114a) must be signed by the taxpayer (and the preparer) and kept by the preparer in the event it is requested by FinCEN. This e-file authorization form is much like the Canadian version for authorizing a third party to e-file a personal tax return (Form T183), though more information is required for the FBAR form.

Shortly after the e-filing rules were enacted, we contacted FinCEN to inquire about the potential for exemptions from the requirement to e-file the FBAR form (allowing paper filing instead). FinCEN indicated that exemptions were not possible for individuals who engage professionals to prepare their FBAR forms. Only individuals who prepare and file their own forms may request an exemption. However, it is still unclear how the individual will paper file Form 114 since a paper version of the form currently does not exist and the former form TDF 90-22.1 is considered obsolete. Furthermore, it is our understanding that each taxpayer will qualify for the e-file exemption only once and only for one year. We expect more flexibility to be offered in the future as FinCEN begins to better understand specific taxpayer concerns, such as limited access to technology, poor computer literacy, and confidentiality concerns, to name just a few.

On the positive side, the electronic FBAR form does offer one interesting new feature. It provides the ability to pull from a list of "reasons" why an FBAR form is being filed late, if applicable. Each option provides a very short reason for late filing, such as "forgot to file" or "did not know that I had to file." There is also an option to choose "other" and provide an explanation. At this time, there is no indication of how the IRS will view and respond to these reasons.

For those who were required to file the FBAR form but were not aware of these requirements, the IRS has issued specific procedures to come forward voluntarily and potentially avoid or reduce the penalties. Individuals in this situation should seek accounting and legal advice before filing late FBAR forms.

Collins Barrow publishes a regular *US Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada with respect to US issues. While *US Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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