US Citizens Living in Canada

Income Tax Considerations

Many US citizens have lived in Canada most of their lives and consider themselves to be Canadians. This may be true in terms of national pride and culture but their citizenship is a differentiator for US income tax filing requirements. US citizenship can be acquired by being born in the US or being born to US citizen parents, but often the tax implications of being a US citizen are overlooked. The US imposes tax on US persons (US citizens, US residents and Green Card holders) on their worldwide income regardless of where they live. Therefore US persons have annual US income tax filing and reporting requirements that exist regardless of where they call home and how little time they spend in the US.

This publication outlines some of the significant US tax issues that can arise for US citizens (including Green Card holders) who are Canadian residents for income tax purposes.

1) I am a US citizen living in Canada. What are my income tax filing and reporting requirements?

US Income Tax Returns – A US citizen residing in Canada should be filing a US individual income tax return (Form 1040) to report worldwide income on an annual basis, in addition to the Canadian income tax return filed as a tax resident of Canada. Although income is reported in both Canada and the US, double taxation is generally mitigated through the use of foreign tax credits. The foreign tax credit mechanism allows for any Canadian income tax paid to reduce the amount of US income tax otherwise payable on the income that is taxable on both the Canadian and US income tax returns.

FBAR Reporting – In addition to the filing of annual US income tax returns, there are a number of information reporting requirements for US citizens. One of the requirements is a Report of Foreign Bank and Financial Accounts (FBAR), Form TD F 90-22.1, which must be filed if you have a financial interest (or signature authority) in one or more accounts in a foreign country and the aggregate value of those accounts exceeds US$10,000.

While there are significant penalties (in addition to possible criminal prosecution) associated with the failure to file individual income tax returns and complying with the FBAR reporting requirements, the IRS has indicated that penalties may be waived if the failure to file the FBAR or a US individual tax return is due to a reasonable cause.

Beginning in 2014, under the new Foreign Account Tax Compliance Act (FATCA), non-US financial institutions will be required to identify and report on accounts held for US citizens.

Although the reporting requirement for foreign financial institutions doesn't begin until 2014, foreign financial institutions are required to begin their process of identifying US citizens who have an interest in financial accounts.

As of the 2011 tax year, there are two additional FATCA disclosure requirements. First, US citizens who have foreign accounts/assets with an aggregate value exceeding a specified amount are required to disclose certain information about these accounts on Form 8938, Statement *of Specified Foreign Financial Assets*. The IRS will use the information reported on this form to ensure that the income attributable to these foreign assets/accounts is properly reported on the individual's US income tax return. A single US citizen/US resident living abroad would be required to complete Form 8938 if they have specified foreign assets with a value that exceeds US$200,000 at the end of the year or US$300,000 at any time during the year. Specified foreign assets can include (but are not limited to: bank accounts, RRSPs, stocks, pensions/annuities, partnerships, trusts, debt instruments, mutual funds and insurance contracts). Form 8938 must be attached to the individual's US income tax return. The disclosure requirement is in addition to the FBAR previously mentioned.

The second reporting requirement that was implemented as of the 2011 tax year requires US citizens who have shares in a passive foreign investment company (PFIC) to disclose certain information regarding their investment in the PFIC on an annual basis. In general, a PFIC is a non-US corporation that derives most of its gross income as passive income or at least half of its assets produce passive income (or are held for the production of passive income). In determining whether or not you have a reporting requirement for a PFIC, it is important to note that a Canadian mutual fund would be classified as a corporation regardless of the fact that it may be classified as a trust for Canadian income tax purposes. As such, if you hold units in a Canadian mutual fund, you may be subject to the new PFIC reporting requirements. In previous years, there was a reporting obligation with respect to PFICs (on Form 8621) only if there were transactions related to the investment (such as a distribution or a sale). However, the Form 8621 must now be filed even if there has been no activity related to the PFIC.

2) I am a US citizen living in Canada but I haven't filed any US income tax returns in the past. Is there a special process available for US citizens who live outside the US to enable me to become compliant?

Recognizing that many US citizens living in other countries have not complied with their US income tax filing and reporting requirements, the IRS recently announced new procedures that came into effect on September 1, 2012. The procedures may provide relief from penalties if you are a US citizen living in Canada and have been unaware of your US income tax obligations and owe a minimal amount of US income tax.

To benefit from these new procedures, you must be a US citizen who has lived outside of the US since January 1, 2009 and has not filed a US individual income tax return during that period. To take advantage of these new procedures, you will be required to submit documentation to the IRS that includes: three years past due tax returns, FBARs for the past six years and a completed IRS questionnaire.

The IRS indicated that they will not likely impose penalties on taxpayers who they determine to be a low compliance risk. Among other criteria, the IRS has indicated that simple income tax returns that show less than US$1,500 in tax due in each of the past three years will generally be treated as low risk. Individuals with a higher risk level may be subject to a more thorough review and possibly a full examination by the IRS. Factors that may increase your level of compliance risk include the use of sophisticated tax planning or avoidance techniques and claims for refunds in any income tax returns submitted through the program.

If you have an RRSP or RRIF in Canada, you should note that the tax-deferred nature of RRSPs/RRIFs is not recognized under US tax law. However, as noted in more detail in the following section, you can file an election under the Canada/ US Income Tax Treaty (the Treaty) to defer the income earned in your RRSP/RRIF for US federal tax purposes (so that it parallels the treatment for Canadian tax purposes). If you have failed to make this election in prior years, you may also be eligible for retroactive relief under these new procedures.

The new procedures were designed for individuals who inadvertently did not comply with US individual tax and reporting obligations. Although these procedures will not protect those who may be subject to criminal prosecution (i.e. those who knowingly have not been in compliance), the new process may provide some relief for many individuals who were not previously aware of their US tax filing and reporting obligations. It should be noted that the Offshore Voluntary Disclosure Program (OVDP), which offers another means for US tax filers to become compliant, will not be available to anyone who makes a submission under these new procedures. As such, it is important to consult with a cross-border tax professional to determine the best course of action for your specific circumstances.

3) Besides the US reporting requirements, what additional income tax considerations do I have as a US citizen who resides in Canada?

Many Canadians may have investments in registered plans such as a TFSA, RESP, RRSP or RRIF. However, a Canadian resident who is a US citizen has additional income tax considerations associated with these savings vehicles.

TFSA – Although the income earned in a TFSA is tax-free for Canadian tax purposes, the income earned is taxable for US income tax purposes and may therefore not always be a recommended investment vehicle for a US citizen.

However, the TFSA may be a beneficial savings vehicle for US citizens residing in Canada if the individual has foreign (such as Canadian) taxes payable on other non-US investment income (held outside of a TFSA), as the foreign taxes payable on that other non-US investment income may be applied to offset some of the US income tax attributable to the TFSA income.

RESP – Similar to the TFSA, the income earned in an RESP is taxable for US income tax purposes.

As such, if either the subscriber and/or the beneficiary of an RESP is a US citizen, the US tax filing and reporting obligations associated with a Canadian RESP should be considered to determine the feasibility of establishing (or maintaining) the RESP. Both TFSAs and RESPs may be considered foreign trusts for US income tax purposes and would require additional annual reporting requirements such as a Form 3520 - *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts* and Form 3520A - *Annual Information Return of Foreign Trust with a US owner*. Completion of Form 8621 (previously mentioned in this publication) may also be required if the TFSA or RESP holds a Canadian mutual fund.

RRSP/RRIF – Although RRSP/RRIF income grows tax-free for Canadian income tax purposes, the annual income earned in an RRSP/RRIF is considered to be taxable income for US income tax purposes. However, in order to mitigate any double taxation, the Treaty provides for some relief. The Treaty provides an election (on IRS Form 8891) that can be made to defer the US income tax on that investment income for US federal tax purposes until the funds are withdrawn. If the treaty election is made, the timing of the taxation becomes the same for both countries and foreign tax credits can be used to minimize any double taxation. The completion of Form 8621 may also be required if the RRSP/RRIF holds a Canadian mutual fund, regardless of the fact that an election has been made to defer the income earned in the RRSP/RRIF.

Transfer of a US Retirement Plan to an RRSP – If you are a US citizen (or former US resident) who has previously worked in the US, you may want to transfer your US retirement plan, such as a 401(k)/IRA, into your RRSP. In general, it is possible for a Canadian resident to transfer a lump sum from a US pension plan into an RRSP if you are under the age of 71. The lump sum transfer of a US retirement pension plan into an RRSP would not affect your RRSP contribution room. However, there are potential US tax consequences on this transfer, namely:

1. A 10% early withdrawal penalty if you are under 59 ½ years of age.
2. US withholding tax on the withdrawal.

As a US citizen, you will have to report the transfer on your US income tax return and your Canadian income tax return. However, you will likely be able to claim a deduction for Canadian tax purposes for some or all of the amount that you transfer into your RRSP. In addition, you may be able to reduce your Canadian income tax payable by claiming a foreign tax credit for any US taxes payable on the 401(k)/IRA transfer. It is very important to estimate your Canadian and US income tax liabilities before you make a transfer from your US retirement plan in order to determine whether or not the transfer is feasible in your particular circumstances.

Capital Gains – While there are favourable US income tax rates (see Appendix A) for long-term capital gains (i.e. gains attributable to assets held for more than one year), the capital gain exemptions that are applicable for Canadian income tax purposes are not applicable for US income tax purposes. For example, if you are a US citizen who sells an asset that is eligible for the lifetime CDN$750,000 capital gains exemption (e.g. the sale of shares of a qualifying small business corporation) for Canadian income tax purposes, you should be aware that the gain is reportable for US income tax purposes and is subject to US income tax. Similarly, while the Principal Residence Exemption is applicable for Canadian income tax purposes, there is no similar principal residence exemption for US income tax purposes. There may, however, be a US$250,000 capital gain exclusion available on the sale of a principal residence for US income tax purposes if certain criteria are met.

4) My family is developing their Canadian estate plan. What issues should I be aware of as a US citizen?

Many Canadian residents undertake some estate planning that commonly results in individuals becoming shareholders of private Canadian corporations or beneficiaries of trusts resident in Canada. If a family member such as a spouse, child or grandchild is a US person (e.g. US citizen, US resident or Green Card holder) and is among the people who will be affected by the planning, US income tax implications should be considered in conjunction with the Canadian income tax considerations. Some possible US tax considerations include:

Controlled Foreign Corporations (CFC) – Broadly defined, a foreign (non-US) corporation is a CFC for US income tax purposes if more than half of the corporation is owned by one or more US citizens. If you are a US citizen who holds shares in a CFC, you may need to include your share of the company's income in your US individual income tax return even if that income was not distributed to you. In addition to the income tax implications, there is an annual US reporting requirement to disclose information about the corporation.

Passive Foreign Investment Company (PFIC) – As defined earlier, a PFIC is a non- US corporation that derives most of its gross taxable income as passive income (e.g. dividends, interest, rent) or at least half of its assets produce passive income. As such, many Canadian holding companies will be considered PFICs as will many Canadian mutual fund companies.

Distributions received by a US citizen from a PFIC are subject to a special set of tax rules which may cause an interest component to be added to the income tax associated with the distributions. In addition, there are information reporting requirements related to PFICs (as mentioned earlier in this publication) which can create practical difficulties in obtaining the information to fulfill these reporting requirements.

Dividends paid out of the Capital Dividend Account – While dividends paid out of a corporation's Capital Dividend Account are not subject to Canadian income tax when received by Canadian residents, the dividends received by a US citizen resident in Canada would be subject to US income tax.

Foreign (non-US) Trusts – If you are a US citizen who is a beneficiary of a foreign trust, the distributions may have to be included in your US income tax return for the year even if the trust has been subject to Canadian income tax.

In addition, if any of that distribution is from income that has been accumulating in the trust, there may be an interest component to the US tax associated with the distribution. In some circumstances where there has been an accumulation of income, distributions of trust capital (which is not taxable for Canadian income tax purposes) may be included as taxable income for US income tax purposes. US beneficiaries of a foreign trust must also comply with annual reporting requirements.

US Estate Tax – As a US citizen, the value of your worldwide assets at the time of your death (in excess of any unused lifetime exemption amount applicable for that year) is subject to US estate tax regardless of where you reside. Since the American Taxpayer Relief Act of 2012 made permanent the existence of US estate tax, estate planning strategies for Canadian tax purposes (including any terms included in trust agreements), should be implemented with the additional goal to minimize the inclusion of any assets into your estate for US estate tax purposes. For example, you may want to be mindful of the fact that life insurance proceeds will be included in the value of a US citizen's estate unless there has been estate planning such as the use of an

Irrevocable Life Insurance Trust (ILIT) or having a non-US citizen family member(s) own the insurance policy. The exclusion amount for US estate tax purposes is US$5.25 million for 2013.

US Gift Tax – As part of the US transfer tax regime (which includes US estate tax), US taxpayers are also subject to gift tax on the lifetime transfer of assets. Accordingly, this gift tax should also be a consideration when implementing any estate or tax planning strategies. Since US gift tax is generally tied to US estate tax, the gift tax lifetime exclusion amount for US citizens is the same as the exclusion amounts applicable for US estate tax purposes which is US$5.25 million for 2013. Any use of the lifetime exemption amount towards gift tax will have a corresponding decrease in the exemption amount available for US estate tax. In addition to the lifetime gift tax exclusion, US citizens can give US$14,000 (annually per recipient) and up to US$143,000 to a non-US citizen/non- US resident spouse without being subject to gift tax. Both of these amounts are indexed annually.

Generation Skipping Tax (GST) – GST is imposed in addition to estate or gift tax when there is a transfer of assets to a recipient that is more than one generation removed from the transferor. For example, a gift from a grandparent to a grandchild may be subject to the GST. The purpose of the GST is to ensure that estate or gift tax is not avoided by skipping one generation level. The rates and exclusion amounts for the GST are the same as the rates and exclusion amounts (US $5.25 million for 2013) for estate and gift tax.

5) I am considering rescinding my US citizenship. What are some issues that I need to be aware of?

Given the numerous US income tax and information reporting requirements imposed on US citizens, especially those who have financial assets located outside of the US, many US citizens have considered rescinding their US citizenship. However, before making this decision, you should be aware that individuals rescinding their US citizenship after June 2008 may be subject to considerable US income tax upon expatriation. In addition, gift tax may be imposed on the recipient of a gift from an expatriate. Unless you qualify for a specific exception to the rules, the “exit tax” provisions are imposed on expatriating individuals who meet any one of the following criteria:

1. Have a net worth over $2 million on the date of expatriation, or
2. Average US income tax liability for the 5 years preceding the date of expatriation exceeds a certain amount that is indexed to inflation (US$155,000 for 2013), or
3. Have not complied with all US federal tax obligations for the 5 years preceding the expatriation date.

Individuals who are dual citizens at birth and meet certain additional criteria, may be exempt from these “exit tax” provisions.

Even if the exit tax does not apply in your circumstances, you should seek the advice of a US immigration attorney to understand any issues that may arise if you decide to work or visit the US after rescinding your US citizenship.

Contact your BMO Nesbitt Burns Investment Advisor for an introduction to an external qualified tax professional.

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The information presented herein is neither a comprehensive review of the subject matter covered nor a substitute for specific professional advice. Because of the complexity and evolving nature of cross-border taxation, and the potential for significant penalties, consultation with a cross-border tax specialist is recommended to review the applicable US and Canadian tax consequences and to co-ordinate the tax implications in both jurisdictions.

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Appendix A—2013 US Income Tax Rates

Tax Rates			
Single Taxable Income Range	Married Filing Joint (MFJ) Taxable Income Range	Ordinary Income Tax Rates[1]	Long-Term Capital Gain and Dividend Tax Rates[1]
\$0 — \$8,925	\$0 — \$17,850	10%	0%
\$8,925 — \$36,250	\$17,850 — \$72,500	15%	0%
\$36,250 — \$87,850	\$72,500 — \$146,400	25%	15%
\$87,850 — \$183,250	\$223,050 — \$398,350	28%	15%
\$183,250 — \$398,350	\$223,050 — \$398,350	33%	15%
\$398,350 — \$400,000	\$398,350 — \$450,000	35%	15%
\$400,000+	\$450,000+	39.6%	20%[2]

Long-Term Capital Gain and Dividend Rates

The top rate for long-term capital gains (defined as capital gains from the sale of assets that were held for greater than one year) and dividends is 20%[1] for taxpayers with incomes in the top income tax rate for ordinary income rate. Capital gains and dividends are permanently at a 0% rate for taxpayers when their ordinary income is taxed at 15% or below (i.e. their taxable income is below \$36,250 for a single filer or \$72,500 for a married taxpayer filing joint). Taxpayers subject to a rate greater than 15% on ordinary income, but below the top ordinary income tax rate threshold of 39.6% will continue to be subject to a 15% rate on capital gains and dividends.

Notes:

(1) Higher income taxpayers (individuals with Modified Adjusted Gross Income over \$200,000 for single individuals and \$250,000 for married taxpayers) must also pay 3.8% additional tax on net investment income to the extent the threshold income amount is exceeded.

Thus the capital gains and dividend tax rate will be 18.8% or 23.8% to the extent the 3.8% surtax on net investment income applies to capital gain and dividend income.

(2) Note that the highest long-term capital gain and dividend rate in the US exceeds the highest marginal tax rate for capital gains and/or eligible dividend for residents in certain provinces such as Alberta and British Columbia. As such, many more US citizens who are Canadian residents may have US income tax owing on their US income tax returns for 2013 and future years.