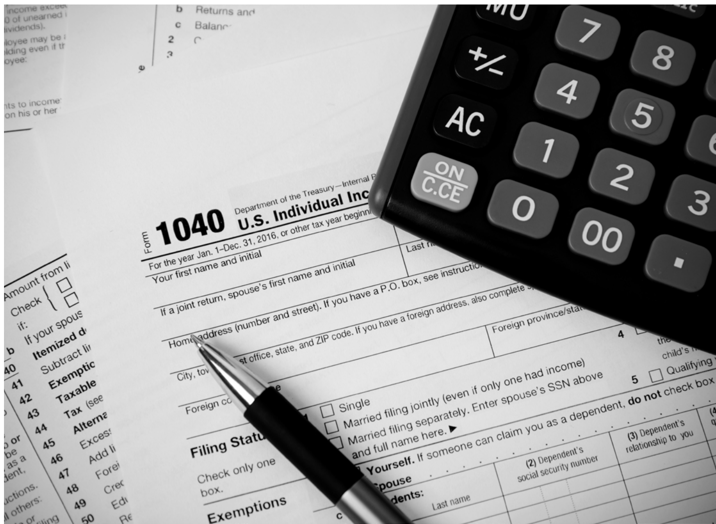
TD Wealth

Top 10 Tax Issues facing U.S. Citizens living in Canada



U.S. citizens are subject to U.S. taxation based on their citizenship, no matter where they live in the world, even if they have never lived in the United States.

An individual may be considered a U.S. citizen if he or she:

- was born in the U.S.;
- successfully applied to become a "naturalized citizen" of the U.S.;
- was born outside of the U.S. to at least one U.S. citizen parent.

1. U.S. tax filing obligations

U.S. citizens are generally required to file a U.S. tax return and make various financial disclosures to the U.S. Internal Revenue Service (IRS). Some of the more common IRS filing requirements for U.S. citizens resident in Canada include:

- **Income Tax Return:** The basic U.S. federal individual income tax return, which must be filed in any year that an individual's gross worldwide income equals or exceeds the total of the U.S. *annual standard deduction*. Under the recently enacted *Tax Cuts and Jobs Act* (the U.S. tax reform bill), the standard deduction amount is US$12,000 for a person filing as single and under the age of 65, who is not eligible to be claimed as a dependent by another person. Thresholds will vary depending upon filing status.

  In general, a U.S. tax return is due by April 15th, however the IRS provides an automatic two-month extension (June 15th) for individuals who live outside of the U.S., and Puerto Rico. An additional extension of up to six months from the original filing due date may be requested. However, for any individual who has U.S. tax-payable and makes a payment after the original filing due date, interest will be charged from the original filing date.

For many Canadians, the taxes paid in Canada are generally greater than the taxes owing in the U.S. When the amount of Canadian tax paid equals or exceeds the amount of U.S. tax that would be paid on the same income, a foreign tax credit is available and will generally offset U.S. tax liability.

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FBAR: A U.S. citizen living in Canada (including minor children) will generally have to file a *Report of Foreign Bank and Financial Accounts* (FBAR). This is filed separately from the U.S. income tax return. Individuals are generally required to file FBAR showing each Canadian (and any other non-U.S.) account in which there is a financial interest, or signing authority, when the total of all such accounts exceeds US$10,000 at any time during the calendar year.

Financial interest is defined as being the owner of record or holder of legal title and for a corporation, having over 50%, by vote or value of the corporation. The due date for the FBAR is April 15th of the year following the calendar year being reported with an automatic six-month extension to October 15th. The FBAR is filed electronically through the Financial Crimes Enforcement Network's (FinCEN) Bank Secrecy Act (BSA) E-Filing System. Penalties for failing to properly file an FBAR are significant, with penalties up to US$10,000 per violation. Penalties for *willful failure* to file may be the greater of US$100,000 or 50% of the balance in the account at the time of the violation.

- **Form 8938 – Foreign Financial Assets:** The F*oreign Account Tax Compliance Act (FATCA)* requires U.S. citizens to report their foreign financial assets with their annual tax return. The threshold for a U.S. taxpayer living abroad filing an individual return is more than US$300,000 at any time during the tax year, or US$200,000 at the end of the tax year. The due date for filing Form 8938 is the same as the due date for your U.S. income tax return, including the extension. If you are required to file regarding foreign financial assets, but if you fail to do so by the due date you may face a penalty of US$10,000.

  FATCA generally requires foreign financial institutions to register with the IRS and disclose information about U.S. account holders including accounts for insurance, bank and investments. Canadian financial institutions report information on "U.S. Reportable Accounts" to the Canada Revenue Agency (CRA), which then exchanges the information with the IRS. Registered accounts and products, including Registered Retirement Savings Plans (RRSPs), tax-free savings accounts (TFSAs), and registered education savings plans (RESPs) are generally not subject to FATCA reporting requirements.

Form 3520: U.S. citizens are required to file a return reporting transactions with foreign trusts and receipt of foreign gifts reporting various transactions with non-U.S. trusts, including the creation of a non-U.S. trust by a U.S. citizen, transfers of property from a U.S. citizen to a non-U.S. trust and the receipt of distributions by a U.S. citizen from non-U.S. trusts. Form 3520 must also be filed when a U.S. citizen receives a gift of money or other property above a certain threshold from a person who is not a U.S. citizen, green card holder or U.S. resident.

2. Not compliant with U.S. filing obligations? What now?

Due to the complexity of U.S. tax laws, U.S. citizens living abroad can easily be non-compliant with their U.S. tax filing obligations. In response, the IRS has launched a series of *voluntary disclosure programs* as well as streamlined procedures to offer relief to U.S. taxpayers who have not complied with their various obligations under U.S. tax laws. The present voluntary disclosure program can allow U.S. taxpayers to report undisclosed income and assets to the IRS, without

criminal penalties, and with reduced monetary penalties. The IRS recently announced that the voluntary disclosure program will be ending on September 28, 2018. When a U.S. taxpayer certifies that their failure to report foreign (non-U.S.) financial assets and pay all the U.S. tax due in respect of those assets was not due to willful conduct, streamlined procedures are available to file amended or delinquent U.S. returns.

3. Canadian registered accounts

U.S. citizens who reside in Canada may establish registered accounts such as a Registered Retirement Savings Plan (RRSP), Registered Education Savings Plan (RESP) or Tax-Free Savings account (TFSA). However, the Canadian tax benefits arising from these registered accounts may potentially be offset by U.S. compliance obligations and/or applicable U.S. taxes.

Retirement Accounts

In Canada, the income earned by Canadian retirement accounts such as RRSPs and Registered Retirement Income Funds (RRIFs) is generally not subject to Canadian income tax until the funds are distributed. Income earned in RRSPs and RRIFs is not tax-deferred under the U.S. Internal Revenue Code. However, under the *Canada-U.S. Tax Convention (the Treaty)* these accounts may receive tax-deferred status in the U.S., and eligible individuals will automatically qualify for the tax-deferred status on income accruing in their RRSPs or RRIFs. Individuals with an RRSP or RRIF should speak to a cross-border tax advisor to determine their eligibility for this tax deferral.

Registered Education Savings Plan

In Canada, an RESP allows money deposited for a child's post-secondary education to grow on a tax-deferred basis. The income is eventually taxed in the child's hands upon withdrawal (assuming the child goes on to post-secondary education). There are also Canadian federal and some provincial government grants that match a portion of contributions to this plan.

Unfortunately, the RESP is not granted the same tax-deferred plan status as RRSPs/RRIFs under the *Treaty*. The income earned within the RESP is generally taxable to the subscriber, i.e., the parent, in the year the income is earned. This includes any interest, dividends, or realized capital gains or losses on the contributions to the plan. Furthermore, any grants received from the Canadian federal or provincial governments, and income earned on such grants are taxable in the year they are received. Subscribers are required to file an information return regarding an RESP as a foreign trust.

Tax-Free Savings Accounts

A TFSA allows Canadian residents who are 18 or older to set money aside to earn investment income that would not be subject to Canadian tax. (Unlike contributions made to an RRSP, contributions to a TFSA do not result in an income deduction for tax purposes.) The annual TFSA contribution limit is $5,500 at present.

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Unfortunately, a TFSA is neither a tax-free nor a tax-deferred account for U.S. tax purposes. Income received or capital gains realized each year must be reported on your U.S. income tax return. Where a TFSA is a financial account, in addition to being taxed annually on the income, it must generally be included in your FBAR filing. When a TFSA is set up legally as a trust, if the IRS views the TFSA as a foreign trust with a U.S. owner, the account owner may be subject to reporting requirements.

4. The tax implications of transferring a U.S. Retirement Plan to an RRSP

Many individuals who have worked in the U.S. have invested funds in U.S. retirement plans, such as Individual Retirement Accounts (IRAs) or 401(k)s. If they move to Canada, they often ask their financial advisors whether they can also move the savings in their U.S. retirement plans to Canada.

From a Canadian tax perspective, the savings in U.S. retirement plans may be withdrawn and then designated as a transfer to an RRSP in Canada. The withdrawal will be subject to U.S. withholding tax, and if the holder of the U.S. retirement plan is under 59 ½ years of age at the time of the withdrawal, the withdrawal may be subject to an addition 10% early distribution tax.

With regard to income tax, the amount withdrawn from the U.S. retirement plan and transferred to a Canadian RRSP would be reported in the individual's Canadian income tax return. A deduction could be claimed on the Canadian return for the amount, and a foreign tax credit for the U.S. taxes, in the year they are paid, may also be claimed. The withdrawal would also be reported on a U.S. income tax return and be subject to U.S. tax. Contributions to an RRSP are generally not deductible in the U.S., with the exception of specific circumstances under the *Treaty*.

In retirement, the possibility of double taxation could arise.

It should be noted that in retirement, the possibility of double taxation could arise. When the funds are eventually withdrawn from the RRSP, or a RRIF, Canadian taxes will apply with no ability to obtain a foreign tax credit to offset any U.S. tax. Foreign tax credits would generally not carry forward to remedy double taxation in this situation. Therefore, a U.S. citizen might want to consider the tax risk involved in transferring U.S. retirement funds to a Canadian RRSP and consider speaking with a cross-border tax advisor about the tax implications of transferring a U.S. retirement plan to an RRSP.

5. Canadian home ownership and eligibility for the Principal Residence Exemption

Generally, Canadian residents are not subject to tax on gains from the sale of their principal residence. Under Canadian tax rules, the principal residence exemption reduces or eliminates the capital gain that would otherwise arise on the sale of your principal residence for each year that you "ordinarily inhabited" the residence.

The U.S. has different tax rules regarding the sale of a principal residence and certain criteria must be met in order to qualify for the exclusion. In addition, the exclusion is limited to a maximum exclusion of US$500,000 from the gain on a sale that is claimed on a "jointly filed return" (or a maximum of US$250,000 on returns filed by single person, head of the household, or married persons filing separate returns). Since the exclusion is subject to a maximum amount, any capital gain exceeding the exclusion amount is subject to tax in the U.S. in the year the home was sold and can result in an unexpected U.S. tax liability.

6. Business Ownership and the Canadian Lifetime Capital Gains Exemption

Under provisions of the Canadian *Income Tax Act*, Canadian residents are generally entitled to a lifetime capital gains exemption (LCGE) of up to CDN$848,252 for the 2018 tax year. It applies to gains realized on the sale of shares of certain closely held corporations (Qualifying Small Business Corporation Shares). The LCGE limit is indexed annually for inflation.

There is no similar exemption under U.S. tax law. Accordingly, U.S. citizens living in Canada will be subject to U.S. income tax (generally, at a rate of 20%) on the entire gain of Qualifying Small Business Corporation Shares.

Shares of private Canadian corporations may be governed by the "Controlled Foreign Corporation" (CFC) rules. In brief, a CFC is a foreign corporation of which more than 50% of the total votes or value of the corporation is owned by U.S. shareholders. A U.S. shareholder generally means a U.S. citizen who owns 10% or more of the total voting power of the foreign corporation's voting shares. A U.S. citizen may need to include as ordinary income certain types of income earned by the CFC in the year, even if no income has been distributed. Individuals who may be affected by the CFC rules should consider speaking to a cross-border tax advisor for more information about the CFC rules and how they could apply.

7. The impact of the Passive Foreign Investment Company (PFIC) Rules

For U.S. tax purposes, a U.S. passive foreign investment company (PFIC) is a non-U.S. corporation that has at least 75% of its gross income from passive income or holds at least 50% of its average fair market value in assets that produce passive income. Passive income is generally investment income including interest, dividends, royalties, etc.

Under the U.S. entity classification rules, Canadian mutual funds and exchange traded funds (ETFs), even those organized as trusts, are generally considered to be corporations. Canadian mutual funds and ETFs may be subject to the PFIC rules. The PFIC rules are punitive and may involve significant reporting requirements. Therefore, for many U.S. citizens living in Canada, it may not be practical to hold Canadian mutual funds or ETFs.

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If a U.S. citizen receives income from a PFIC or recognizes a gain from the disposition of shares of a PFIC, the unfavourable U.S. income tax consequences generally include the following:

- "Excess distributions" (a distribution in excess of 125% of the distributions received by the U.S. person over the last three years or their holding period, if shorter) are subject to tax at the highest marginal rate, rather than at the taxpayer's marginal rate, plus a non-deductible interest charge; and
- Any gain on the sale of the shares is treated entirely as an excess distribution (therefore the preferential long term capital gains tax rate would not apply).

A U.S. shareholder of a PFIC may make a qualified electing fund (QEF) or mark-to-market election to help mitigate the adverse tax consequences of the PFIC rules.

In general, U.S. citizens who own shares of a PFIC must file an annual information return.

Given the potentially unfavourable U.S. tax implications for U.S. citizens living in Canada, careful consideration of the PFIC rules should be factored into any analysis of whether to purchase a Canadian mutual fund or ETF.

8. U.S. Estate Tax

As a U.S. citizen living in Canada, an individual may be subject to both the Canadian and U.S. tax regimes upon their death.

As a U.S. citizen, an individual will be subject to U.S. estate tax on the fair market value of his/her worldwide estate at the time of their death. Worldwide estate includes all property owned at death, regardless of where the property is located.

The U.S. estate tax rate starts at 18% and goes up to 40% when the value of an estate reaches US$1,000,000. A U.S. citizen, is entitled to a unified lifetime exclusion amount of US$11.18 million in 2018 (the amount is indexed annually), for estate and gift tax (see consideration #9, below). This means that as long as no portion of the exclusion amount was used towards gift tax, no estate tax is payable if your worldwide estate is valued at less than US$11.18 million in 2018. Individuals may also be entitled to a marital deduction or marital credit if the assets pass to a surviving spouse.

Some relief from double taxation may be available under the *Treaty*. Canada allows a federal credit for U.S. estate tax payable on property situated in the U.S. The U.S. provides a credit for Canadian taxes payable at death on the deemed disposition of your property located outside of the U.S.

It should be noted that the recently enacted U.S. tax reform bill, doubled the lifetime exclusion amount from US$5.6 million to US$11.18 million (indexed annually)

for 2018 through 2025. However, unless permanent legislation is enacted, the exclusion amount will return to the pre-2018 exclusion amount, subject to inflation adjustments for 2026. Those who may be affected should consider speaking to a cross-border tax advisor about estate planning considerations with regard to taxes on death.

9. The U.S. Gift Tax Regime

The U.S. imposes gift tax on transfers of property when the transfer is gratuitous (or consideration received is less than fair market value) and less than fair market value is received in exchange for the gift. This gift tax is imposed on the donor. It should be noted that gifts to a U.S.-citizen spouse are generally not subject to gift tax. However, if a spouse is not a U.S. citizen, the giftor will be subject to gift tax if an annual gift to a spouse is more than US$152,000 (in 2018, indexed annually).

The lifetime exclusion amount of US$11.18 million (in 2018) may be used to reduce or eliminate gift tax on significant gifts made within a year. However use of the lifetime exclusion amount to reduce gift taxes would reduce the amount available for estate tax (please see issue #8, above).

In addition, a U.S. citizen is entitled to an annual exclusion of US$15,000 (in 2018) per individual for gifts made to anyone other than a spouse. For example, a parent with three children, can gift up to US$15,000 to each of the children, or a total of up to US$45,000 and not be subject to U.S. gift tax.

Gifts below the annual exclusion amount are not required to be reported on a Form 709 — *U.S. Gift (and Generation-Skipping Transfer) Tax Return*. If a gift exceeds the annual exclusion amount, no gift tax may be owed where the lifetime exclusion amount is claimed however a U.S. gift tax return would need to be filed.

Consider speaking to a cross-border tax advisor about how the U.S. Gift Tax Regime applies when making significant gifts.

10. Renouncing U.S. Citizenship

Given the onerous U.S. income tax and information reporting requirements imposed on U.S. citizens, some U.S. citizens consider renouncing their U.S. citizenship. The act of "expatriation" typically results in the individual being considered a non-resident of the U.S. for income tax purposes, and therefore subject to U.S. income tax only on U.S.-source income, and subject to estate and gift tax on U.S. situs property such as U.S. real estate or U.S. securities. Prior to making this decision, individuals should consider the potential consequences of expatriation:

1. U.S. exit tax rules, similar to Canada's deemed disposition on emigration;
2. acceleration of income recognition for some items, such as pension plans;
3. increased withholding on certain U.S.-source income items; and
4. a gift tax on future gifts and bequests to U.S. citizens, green card holders or U.S. residents.

These consequences generally apply if you are a "covered expatriate" (CE). In general, a CE is someone who meets one of the following three tests:

1. your net worth exceeds US$2 million on the date of expatriation (the net worth test);
2. your average annual U.S. income tax for the five years preceding the year of expatriation exceeds US$165,000 (the tax liability test); or
3. you failed to certify that you have complied with all U.S. tax obligations for the five years preceding expatriation.

Please note that the net worth and tax liability tests may not be applicable to certain dual citizens of the U.S. and another country; and certain U.S. citizens who are under 18.5 years of age.

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