Tax & Estate

United States tax compliance issues for Canadian residents – *Glossary*

This glossary covers some key terms and issues relevant to Canadian residents with individual tax reporting obligations to the United States. U.S. tax administration is generally under the Internal Revenue Service (IRS), the equivalent of our Canada Revenue Agency (CRA), though some procedures may go through other government agencies.

Though some references herein refer to other types of taxpayers (e.g., corporations and trusts), the focus is mainly on natural persons.

This glossary intends to provide an overview of key terminology, so bear in mind that qualifying conditions and/or exceptions may apply to some of these terms. For comprehensive information concerning these topics or individual items, please consult with a tax specialist.

Formatting note: Underlining indicates that a term is being defined in place, or is a topic defined in its own section within this document. For ease of scanning the document, dollar amounts and form numbers are shown in **boldface** text.

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1. U.S. person

The term "United States person" (U.S. person) includes a U.S. citizen or resident alien of the United States, as well as domestic corporations, estates and partnerships. It extends to trusts controlled by a U.S. person or over which a U.S. court has primary jurisdiction.

2. U.S. citizen

An individual is a U.S. citizen if born in the United States, Puerto Rico, Guam or the U.S. Virgin Islands.

A person born outside the U.S. with at least one U.S.-citizen parent *may* be a U.S. citizen. Numerous factors can affect the determination, including date of birth, application before or after age 18, years the U.S. parent resided in the U.S., parents' marital status and more. As well, significant rule changes occurred in or revolve around the years 1952, 1986 and 2001.

Generally, a citizen must make an intentional positive action in order to lose/end citizenship. An application and grant of citizenship in another country does not automatically revoke U.S. citizenship.

3. Resident alien and non-resident alien

The U.S. uses the term alien to mean a person who is not a U.S. citizen or a U.S. national (an individual born in certain U.S.-protected territories).

A resident alien is effectively subject to the same U.S. tax reporting obligations as a U.S. citizen, whereas a non-resident alien is generally subject to U.S. income tax only on U.S.-source income.

For U.S. tax purposes, a person will be considered a resident alien if one of two tests is met: the green card test or the substantial presence test.

4. Green card test

Under the green card test, a person is considered a resident alien on the date that person is given the privilege to reside permanently in the United States as an immigrant, generally by the U.S. Citizenship and Immigration Services (USCIS) issuing **Form I-551** ("Alien Registration Receipt Card"), also commonly known as a "green card."

Resident status continues unless it is terminated by USCIS, or the person makes a voluntary renunciation in writing. Accordingly, the U.S. may consider the person to be a resident alien for tax purposes, despite that the person no longer resides in the U.S.

5. Substantial presence test

Under the substantial presence test, a person is considered a resident alien if he/she has been physically present in the U.S. for (i) at least 31 days during the current year and (ii) at least 183 days during the past three years as determined by the calculation below:

- The total number of days present in the U.S. during the current year,
- 1/3 of the number of days present in the U.S. in the first year before the current year, and
- 1/6 of the number of days present in the U.S. in the second year before the current year.

Despite meeting this test, a person may be treated as a non-resident alien if proof is provided to show a closer connection to a foreign country, like Canada, using **IRS Form 8840** ("Closer Connection Exception Statement for Aliens"). The Canada-U.S. tax treaty is a last-resort route to show closer connection to Canada.

6. Filing a U.S. income tax return

Most countries tax residents only. The United States taxes both U.S. citizens (wherever they may be) and resident aliens.

U.S. citizens and resident aliens use **Form 1040** to file individual federal income tax returns. An annual income tax return must be filed for any tax year in which gross income is equal to or greater than the applicable exemption amount and standard deduction. (Without commenting on how they are used, for 2015 the basic personal exemption amount is **US$4,000** and the individual standard deduction is **US$6,300**.)

The individual filing deadline is April 15, or the next business day if the due date falls on a holiday or weekend.

7. Taxpayer identification number

A Taxpayer Identification Number (TIN) is required to file a tax return with the IRS.

For U.S. citizens, a TIN is a Social Security Number (SSN).

For individuals who are not eligible for an SSN (e.g., certain non-resident and resident aliens), an Individual TIN (or ITIN) is a valid TIN.

8. FBAR

FBAR stands for Foreign Bank Account Report, and refers to form **TD F 90-22.1**. This form was renamed **FinCEN Form 114** ("Report of Foreign Bank and Financial Accounts"). A U.S. person who holds at least **US$10,000** in foreign financial accounts (including certain foreign non-account investment assets) must make an annual filing electronically, irrespective of income, using **FinCEN Form 114**.

The FBAR must be filed annually with the Financial Crimes Enforcement Network (FinCEN), a bureau within the U.S. Department of the Treasury. It must be received by June 30 (for reporting the preceding calendar year).

Penalties: Up to **US$10,000** if non-wilful; if willful, up to the greater of **US$100,000** or 50% of account balances. Criminal penalties may also apply.

9. OVDP/OVDI

The current Offshore Voluntary Disclosure Program (OVDP) has been in place since January 2012, though it was somewhat modified in July 2014. It is a continuation of the 2009 OVDP and 2011 OVDI ("Initiative").

The stated IRS objective is to bring taxpayers who have used undisclosed foreign accounts and assets, including those held through undisclosed foreign entities, to avoid or evade tax in compliance with U.S. tax and related laws.

On an OVDP filing, the IRS may waive the most severe penalties, and criminal sanctions may be avoided. However, taxes, interest and some penalties will still apply.

(Part of the concern about complying voluntarily is that it has been reported that the IRS may not have actually waived penalties as promised when some people made their disclosures. The 2011 report of the IRS ombudsman referred to a watchdog article accusing IRS of "bait and switch.")

10. FATCA

The U.S. *Foreign Account Tax Compliance Act* (FATCA) had originally been a stand-alone bill but was later incorporated into the U.S. *Hiring Incentives to Restore Employment (*HIRE*) Act*, passed in 2010. Details of FATCA have been passed as FATCA regulations. Under FATCA, foreign financial institutions (FFIs) will have to report accounts held by U.S. persons to the IRS. If an FFI fails to report, the IRS levies a 30% withholding tax on the FFI and its clients.

As of July 1, 2014, FFIs had to begin reporting on new client and/or account openings of at least **US$50,000**. FFIs will have to report on pre-existing accounts as of June 30, 2016.

To facilitate FATCA reporting, Canada has negotiated an intergovernmental agreement with the U.S., enacted the *Canada-U.S. Enhanced Tax Information Exchange Agreement Implementation Act* and amended the *Income Tax Act* (Canada). Canadian FFIs will report to the CRA, which will facilitate the information exchange with the IRS.

In addition to requiring compliance from FFIs, FATCA also requires U.S. persons themselves to provide disclosure using the new **Form 8938**.

11. Form 8938

Under FATCA, U.S. taxpayers who hold an aggregate of **US$50,000** or more at the end of the year or **US$75,000** or more at any time during the year in foreign accounts will be required to file a **Form 8938** ("Statement of Specified Foreign Financial Assets") with their annual tax return.

The threshold reporting requirement for non-residents is **US$200,000** or more at the end of the year or **US$300,000** or more at any time during the year, though a tax professional should be consulted to confirm qualification for this higher threshold.

The thresholds are doubled for married individuals filing a joint return.

Penalties: Up to **US$10,000** initially and up to **US$60,000** for continuing failure after IRS notice. Criminal penalties may also apply.

12. PFIC

The U.S. Passive Foreign Investment Corporation (PFIC) rules force disclosure of information about and income details for certain foreign investment structures owned by U.S. persons. Due to an IRS policy change in 2010, non-U.S. mutual funds held by U.S. persons are now considered PFICs.

Generally, a Canadian mutual fund is a PFIC if either of the following tests is satisfied:

1. Income test: 75% or more of gross income for the year is passive income
2. Asset test: 50% or more of the assets for the year are held for the purpose of producing passive income

A U.S. person holding a Canadian mutual fund is required to annually report such holdings to the IRS using **Form 8621** ("Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"). On that form, the income of the PFIC must be reported in one of two ways:

Mark-to-market – The annual change in value is considered regular income, irrespective of the actual underlying income within the PFIC. Losses are treated as regular losses.

Qualifying electing fund – The taxpayer reports his/her proportionate share of the type and amount of the PFIC's income, requiring the PFIC to provide a detailed annual information statement for the purpose.

If the taxpayer does not make either election, the PFIC will be treated as a 1291 fund (per section 1291 of the *Internal Revenue Code*) and be subject to *excess distribution method* reporting. Gains on disposition will likely be taxed at the highest U.S. tax rate at the time, with interest levied for implied underpaid taxes during the holding period.

Where a Canadian mutual fund is held within a registered retirement savings plan (RRSP)/registered retirement income fund (RRIF), the **Form 8621** disclosure and filing obligation would not apply so long as the **Form 8891** filing was kept up to date (see revised procedure below).

Even under the best circumstances and treatment, PFIC characterization can be costly in terms of both tax due and the cost to engage professionals to assist in compliance.

13. Form 8891 – RRSPs and RRIFs

Previously, to benefit from tax-sheltering within an RRSP/RRIF, a U.S. person must have filed **Form 8891** ("U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans") annually. On October 7, 2014, the IRS issued a revenue procedure that eliminated the need to file **Form 8891** to benefit from tax-sheltering. The new procedure became effective in January 2015 and applies automatically and retroactively, even if individuals failed to file **Form 8891** in previous taxation years, as long as they have been and continue to be compliant with their U.S.-tax-filing obligations.

On this latter point, individuals must have attempted compliance for each taxable year or request IRS approval to late-file an election, with failure to comply resulting in onerous penalties. Note that starting in 2012, an interest in an RRSP/RRIF must have been reported on IRS **Form 8938**, in conjunction with **Form 8891**. Beginning in 2014, the IRS no longer required individuals who hold an interest in an RRSP/RRIF and who are required to file **Form 8938** to complete **Form 8891**. On a go-forward basis, it appears that where the exemption to file **Form 8891** applies, IRS **Form 8938** or **FinCEN Form 114** must be used to disclose an interest in an RRSP/RRIF.

14. IRA, 401(K) and 403(B)

An individual retirement account (IRA) is roughly the equivalent of a Canadian individual RRSP.

A 401(K) is a tax-sheltered retirement plan funded by a private-sector employer, though it may also include employee contributions. The closest similar program in Canada might be a group RRSP.

A 403(B) is like a 401(K), except that it is for public-sector and non-profit employers.

15. Roth IRA

A Roth IRA is a retirement account that is funded with after-tax money, benefits from tax-sheltered accumulation and makes non-taxable distributions. In these respects, it is similar to the Canadian tax-free savings account (TFSA).

Whereas TFSA room is independent of RRSP/registered pension plan (RPP) room, the annual contribution limit for a Roth IRA is tied to the person's other tax-sheltered pension and retirement plans.

16. Transferring a U.S. pension to Canada

If a U.S. person intends to remain permanently in Canada, he/she may wish to migrate U.S. pension assets to a Canadian plan. While it is not possible to make a direct transfer to a Canadian RRSP/RPP, a two-step process is allowed to effectively bring about the same result.

Deregistration of a Canadian resident's foreign pension (including a U.S. pension) brings the Canadian-dollar equivalent into the Canadian resident's taxable income. The taxpayer is then entitled to a special RRSP/RPP deduction that does not require or reduce existing RRSP/RPP room.

U.S. withholding tax is addressed and factored in under the Canada-U.S. tax treaty. However, the pension administrator's business process may affect this determination. As well, penalties charged for early withdrawals before age 59.5 may not be creditable in Canada.

17. Registered plans not covered by treaty

The Canada-U.S. tax treaty protects against double taxation issues respecting RRSPs and RRIFs (discussed elsewhere in this document). However, other familiar Canadian registered investment plans are effectively unknown to U.S. tax administration.

TFSAs, registered education savings plans (RESPs) and registered disability savings plans (RDSPs) are not included in the treaty, nor acknowledged in any other official capacity in the U.S. Such plans will be currently taxable to U.S. persons, despite having tax-sheltered characteristics for Canadian residents. As these plans are not taxable (or not currently taxable) in Canada, there will be no usable foreign tax credit for U.S. taxes paid. This can be especially problematic for RESP subscribers when a U.S. person finds him/herself currently taxed on that income for U.S. tax purposes, and yet ultimately the plan beneficiary may be the only taxpayer entitled to the income from a Canadian perspective.

18. Expatriation tax

Expatriation tax provisions apply to U.S. citizens who renounce citizenship and to long-term residents who end their U.S. resident status.

Differing sets of rules apply (with some overlap) for expatriation:

- Pre-June 4, 2004
- June 4, 2004 to June 15, 2008
- Post-June 15, 2008

The last time period has more stringent rules for individuals whose average annual net income tax for the past five tax years has been more than **US$160,000** (in 2015) and for high-net-worth individuals (**US$2 million**).

The rules are very complex, but the starting point is that property is deemed disposed (with some possible deferrals) and tax reporting must be otherwise up to date (specifically the last five years' filings).

19. U.S. transfer taxes

The U.S. estate tax applies to worldwide property of the estate of a U.S. person. For non-U.S. persons, it is levied on the value of U.S.-situs property, including mainly U.S. real estate and U.S. securities (both equity and debt).

An annually indexed exclusion amount is allowed before tax begins to apply, which is **US$5.43 million** in 2015. (This may also be referenced by the unified credit value of **US$2.12 million**, being the amount of estate tax otherwise due on the exclusion amount.) Graduated rates begin at 18%, rising to 40% for taxable estate property over **US$1 million**. The exclusion amount for non-U.S. persons is only **US$60,000**, but under the Canada-U.S. tax treaty, Canadians are generally entitled to the same exclusion amount/treatment as U.S. persons.

The U.S. gift tax applies to gifts by U.S. persons and to gifts of certain U.S.-situs property by non-U.S. persons. Annual exclusions and lifetime exclusions may be available, the main one being the **US$14,000** annual exclusion for gifts by U.S. persons. The annual exclusion for a gift to a non-U.S. citizen's spouse is higher (**US$147,000** for 2015). Use of these exclusions reduces the estate-tax exclusion.

A generation-skipping transfer tax captures gifts made to unrelated persons between 12.5 and 37.5 years younger than the transferor and to related persons two generations below the transferor. See our *Tax & Estate InfoPage* titled *U.S. estate tax planning for Canadians*.

20. Canadian with U.S. rental property

As a U.S. non-resident, a Canadian resident with U.S. rental property may have U.S. reporting obligations. For rents received, the Canadian can either:

- withhold and remit 30% withholding tax on the gross rent; or
- file a U.S. tax return, calculating net rental income.

Rental income must be calculated according to U.S. tax-reporting rules, including the requirement to claim annual depreciation on the property, which could in turn have implications for tax reporting on disposition. Unless there are substantial amounts at issue, the simpler of the two methods is obviously to withhold and remit.

A Canadian who sells U.S. property (whether or not it had been rental property) may be subject to a 10% withholding tax if the sale proceeds exceed **US$300,000**. With proper planning, complete or partial exemptions may apply (subject to certain conditions) as Canadian taxpayers may be able to leverage reduced withholding rates granted under the Canada-U.S. tax treaty or other exemptions.

A Canadian will require an ITIN in order to file a tax return for net rental income or to recover withheld tax on a property sale.

21. Canadian Form T1135

Form T1135 is *not* a U.S. reporting obligation but is sometimes confused as such. It is a CRA form for Canadian residents (including U.S. persons) to report foreign-asset holdings. It was amended for 2014 and following years, requiring significantly greater detail. The form must be filed any year when the cost base of a Canadian resident's specified foreign holdings exceed **C$100,000**.

The 2015 Federal Budget proposes to simplify the foreign-asset reporting for Canadian residents required to file **Form T1135** where their specified foreign holdings are less than **C$250,000**.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

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