

## U.S. Citizens Living in Canada – Income Tax Requirements

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### U.S. Citizens living in Canada

#### General Requirements

Personal income tax laws differ greatly between Canada and the United States of America. One of the primary differences is that Canadian income tax laws are based on **residency**, while U.S. tax laws are based on **citizenship**. For the sake of simplicity this means that if an individual is a full-time permanent resident of Canada, then the person will be taxed on their worldwide income in Canada. It doesn't matter whether the person's citizenship is U.S. or some other foreign nationality, they are taxable in Canada. If a Canadian citizen or resident at some point leaves Canada for a different country, and severs all ties with Canada, they are no longer a resident of Canada and not subject to Canadian income tax laws.

U.S. citizens on the other hand, have an ongoing obligation to declare and report their worldwide income to the U.S.A., regardless of where they reside. U.S. citizens who have permanently departed the U.S.A. and have become full-time permanent residents of Canada are still required to file U.S. income taxes on an annual basis with the Internal Revenue Service (IRS). The only way for U.S. citizens to avoid this would be to go through a process to renounce their U.S. citizenship, which is not practical or desirable for most people. Therefore, a U.S. citizen who resides in Canada is essentially subject to the same U.S. filing requirements as they would if they continued to reside in the U.S.A. This means filing U.S. Form 1040 every year, and reporting worldwide income.

The bottom line for U.S. citizen residents of Canada is that they must file two returns each year - a Canadian income tax return because they reside in Canada, and a U.S. return based on being a U.S. citizen. The Tax Treaty between Canada and U.S.A. has several mechanisms available known as foreign tax credits, to make sure the person does not have to pay duplicate taxes to both countries.

#### Forms to File

The **1040 form** is the standard documentation for filing U.S. income tax returns to the Internal Revenue Service (IRS). Besides filing an annual tax return, the U.S. citizen will most likely be required to submit documentation to the U.S. Treasury. This form is the **TD F 90-22.1 Foreign Bank Account Reporting (FBA)** which essentially provides the U.S. Treasury with information on their Canadian bank accounts and other financial holdings (See note below). Additional reporting is required if the person owns investments such as a whole life insurance policy, Tax Free Savings Account, Registered Education Savings Plan etc.

Note – the FBAR form must be filed annually to report direct or indirect financial interests in all foreign accounts if the aggregate value exceeds US\$10,000 at any time in the calendar year. Disclosure of this information is mandatory. U.S. citizens who are required to file an FBAR and fail to properly file may be subject to a civil penalty not to exceed \$10,000 per violation. If there is reasonable cause for the failure and the balance in the account is properly reported, no penalty will be imposed. A person who willfully fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation.

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U.S. citizens who don't meet their obligation to report the required information to the IRS will soon have to deal with the fact that details on their Canadian accounts will be provided to the IRS from another source—Canadian banking institutions are now putting systems in place to report all accounts held by U.S. citizens. This is a new requirement of The Foreign Account Tax Compliance Act (FATCA) that will come into effect in 2013 (extended to 2014 for Canadian financial institutions).

### **Foreign Earned Income Exclusion**

U.S. citizens may be able to exclude up to \$92,900 from 2011 earned income for U.S. tax purposes by completing **Form 2555** or **Form 2555 EZ** and attaching it to the 1040 Form. Form 2555 and 2555 EZ are special forms which exclude foreign earned income from taxation in the United States. To claim this exclusion the person must meet 7 specific criteria which include 3 residency tests: Bona Fide resident of Canada, Physical Present in Canada for at least 330 days during the last 12 months, and whether Canada was the 'Tax Home' country. If a U.S. citizen has earned income less than \$92,900 in 2011, then the person may be able to complete Form 2555 EZ. In either case, this would be attached to the 1040 form.

### **Tax Treaty Benefits**

In most cases, treaty benefits are not available to U.S. citizens by virtue of Article XXIX, paragraph 2. This provision states that nothing in the treaty can prevent the U.S. from taxing its own citizens, except for those articles listed in paragraph 3. One of these exemptions is the article governing Social Security payments. This means that if a U.S. citizen receives Social Security benefits from the U.S.A., these benefits are not taxable in the U.S. They are taxable only in Canada. A 15% deduction can be claimed on Line 256 of the T1 Canadian tax return.

### **Foreign Tax Credit or Deduction**

As mentioned previously, U.S. citizens can avoid duplicate taxation by claiming a foreign tax credit on the U.S. return for taxes required to pay to Canada. To claim the credit, **Form 1116** must be completed and attached to the U.S. return. Alternatively, Canadian taxes paid can be claimed as an itemized deduction. Both the deduction and credit are limited to foreign income that is subject to U.S. tax, so neither can be claimed for income excluded on Form 2555.

### **Filing Deadline**

U.S. citizens living in Canada have an automatic extension of two months to file their U.S. tax return. This means that the U.S. return is due on June 15 each year, rather than April 15. This provides time for U.S. citizens to complete their Canadian income tax return and determine their Canadian tax liability. This extension is needed in the event that the person needs to claim the foreign tax credit on their U.S. return. However, it is important to note that the IRS will begin assessing interest on any unpaid balances as of April 15<sup>th</sup>.

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### **Back Filing**

Many US citizens permanently living in Canada were not aware of their requirements to file annual income tax returns and FBAR forms. For instance, a U.S. citizen might have moved to Canada as a child with their family and never returned to the U.S. The person is now an adult and permanently residing in Canada on a full-time basis. The IRS has indicated that U.S. citizens such as these, and all others for that matter, should prepare and file the required forms (1040, 2555, TD F 90-22.1, 1116 etc) for a minimum of the last six years, or as far back as the documentation permits. Except for TD F 90-22.1 which requires the most recent form to be used, all other forms should be completed separately for each year, using the forms applicable to each of those taxation years and submitted to the required IRS taxation centre. No penalties or past due interest are payable if no taxes are owed to IRS.

### **Questions**

For further Canadian personal income tax information for U.S. citizens living in Canada, please contact:



On June 26, 2012 the IRS offered new procedures that will allow taxpayers who are low compliance risks to get current with their tax requirements without facing penalties or additional enforcement action. These people generally will have simple tax returns and owe \$1,500 or less in tax for any of the covered years. Taxpayers using the new procedures will be required to file delinquent tax returns (1040, 2555, 1116 etc) along with appropriate related information returns for the past three years, and to file delinquent FBARs (FBAR form TD F 90-22.1) for the past six years. Submissions from taxpayers that present higher compliance risk will be subject to a more thorough review and potentially subject to an audit, which could cover more than three tax years.

The IRS also announced that the new procedures will allow resolution of certain issues related to certain foreign retirement plans (such as Canadian Registered Retirement Savings Plans). In some circumstances, tax treaties allow for income deferral under U.S. tax law, but only if an election is made on a timely basis. The streamlined procedures will be made available to resolve low compliance risk situations even though this election was not made on a timely basis.

The new procedures are effective September 1, 2012.