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Tax Consequences for U.S. Persons in Canada

To ensure compliance with the U.S. Treasury Department regulations, we inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the *Internal Revenue Code* or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Given the close relations between Canada and the U.S., it is not uncommon to find U.S. citizens living in Canada. Some may be in Canada as the result of a temporary employment transfer, while others may have been living here for several years. As a U.S. citizen, you continue to have obligations for U.S. tax purposes, even though you may be resident in Canada. Note that these obligations also apply to “Green Card” holders who are treated like U.S. citizens for U.S. tax purposes. This bulletin outlines various U.S. tax obligations that these U.S. persons need to be aware of, even while living in Canada.

U.S. income tax requirements

Liability for U.S. income tax is based on citizenship, as well as residence. As a U.S. person, you must file annual U.S. income tax returns regardless of where you live or how long you have been away from the U.S. For U.S. tax purposes, you must report your worldwide income from all sources. You can, however, claim a credit against your U.S. tax liability for taxes you pay in Canada or where the income is earned. In many cases, the credit will be enough to eliminate any U.S. tax liability since Canadian taxes are generally higher.

As a result of the U.S. alternative minimum tax (AMT), in some cases prior to 2005, there was an additional U.S. tax liability that couldn't be eliminated with a foreign tax credit claim. However, for taxable years beginning after December 31, 2004, the U.S. AMT rules have changed so that many U.S. persons resident in Canada may not be subject to the additional AMT. Note that other non-tax information reporting requirements may apply.

Canadian tax law will limit foreign tax credit claims allowed to U.S. persons. It is Canada's position that foreign tax credits will only be permitted for taxes that would be paid by Canadian residents (non-U.S. persons) in a similar situation. This may result in additional tax costs for U.S. persons living in Canada.

Filing deadlines

Normally you must file your U.S. return for a particular year no later than April 15th of the year following the year in issue. However, there is an automatic extension to June 15th if you are resident outside the U.S. on April 15th. For example, if you are a U.S. person and are resident in Canada on April 15, 2009, you must file your 2008 U.S. tax return by June 15, 2009.

Penalties

If you ignore your U.S. filing obligation because you do not owe any U.S. taxes and the Internal Revenue Service (IRS) discovers that you did not file, you may lose the right to make certain important elections, such as the election to defer income earned in a Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF) (discussed in the next section), or to claim the “foreign earned income exclusion”. In the case of the foreign earned income exclusion, the exclusion could be denied if the tax return is not filed within one year of the original April 15th deadline for that year.

In addition to penalties and the potential loss of certain elections, problems can arise when you decide to return to the U.S. if you have not complied with your U.S. tax obligations while you were away. Previously unpaid taxes and late returns (which may subject you to interest and penalties) can make returning to the U.S. much more difficult.

In other cases, problems may arise on your death if you die owing unpaid taxes or if you failed to file returns, especially if your executor is also a U.S. person (perhaps, a son or daughter living in the U.S.). For example, the executor can be held personally liable for the unpaid tax liabilities of the estate.

If you travel on a U.S. passport, you may have difficulty getting your passport renewed if you cannot provide evidence that all required tax filings have been made.

Some taxpayers – especially those who do not plan on ever living in the U.S. again – take the position that the IRS will never catch up with them if they live in Canada and even if the U.S. government does, it would never be able to collect. Well, that’s not true. Under the Canada-U.S. tax treaty, the IRS can solicit the Canada Revenue Agency’s (CRA’s) assistance in collecting unpaid taxes from U.S. persons residing in Canada which the IRS has established to have been due in the last 10 years.

If you have not been filing your U.S. income tax returns, it appears that the IRS will permit you to file tax returns for the past three years to bring yourself up to date (note that if you have a tax liability in any of the past three years, the IRS will want two more years of past returns for a total of five years). However, the IRS

reserves the right to go back further than five years. Contact your BDO tax advisor for assistance with filing your U.S. income tax returns.

U.S. reporting rules for RRSPs and RRIFs

If you own a Canadian RRSP or RRIF, under U.S. domestic law, you are required to include income and gains earned inside your RRSP or RRIF in your taxable income for U.S. tax purposes on a current year basis, rather than when this income is withdrawn (which is the case for Canadian tax purposes). Due to this timing mismatch, double taxation can result. However, there is relief under the Canada-U.S. tax treaty, which allows a U.S. person to elect to defer recognition of the income and gains in their U.S. taxable income until such time as the income is withdrawn from their RRSP or RRIF. Where this election is made, the timing of the taxation of the accrued RRSP or RRIF income will be the same in Canada and the U.S.

However, the election can generally only be made if you file your U.S. income tax return for the year in question on time. As discussed below, Form 8891 is used to make the election to defer RRSP and RRIF income not yet withdrawn.

The IRS has special reporting requirements for U.S. persons who have RRSPs or RRIFs (which apply whether or not an election has been made to defer current taxation of income earned in the RRSP or RRIF for U.S. purposes). Form 8891 must be completed if you hold an interest in an RRSP or RRIF, and the form must be attached to your U.S. tax return. The three purposes of this form are as follows:

- ◆ to report distributions received from Canadian RRSPs and RRIFs,
- ◆ to report contributions and undistributed earnings, and
- ◆ to make the election to defer U.S. income tax on income in an RRSP or an RRIF that has accrued, but has not been distributed.

A separate Form 8891 must be filed for each RRSP or RRIF for which there is a filing requirement. In the situation where you and your spouse file jointly, Form 8891 must be filed for each spouse. Annuitants and beneficiaries who are required to file Form 8891 will not be required to file Form 3520 – the *Annual Return to Report Transactions with Foreign Trusts*.

The IRS has indicated that taxpayers must retain supporting documentation for the information required to be reported, including Canadian forms T4RSP, T4RIF, or NR4 and periodic or annual statements issued by the custodian of the RRSP or RRIF.

Other Canadian deferred income plans

As discussed earlier, Canada and the U.S. have worked together over the years to ensure that treatment of RRSPs and RRIFs by each is consistent. However, you should not assume this is true for all Canadian investments where special tax rules apply. For example, problems can arise where a U.S. person holds a Registered Education Savings Plan (RESP) or a Retirement Compensation Arrangement (RCA), as discussed below.

Canadian RESPs

U.S. persons living in Canada can invest in RESPs – but doing so may have negative consequences for U.S. tax purposes. The main disadvantage is that, unlike RRSPs and RRIFs, U.S. persons cannot elect to defer the taxation of income earned in an RESP.

The U.S. tax implications for RESPs depend mainly on the residency of the contributing parent and the beneficiary child.

Contributing Parent is a U.S. Citizen or Resident (Foreign Grantor Trust): The income earned within the plan (excluding unrealized capital gains, but including Canadian Education Savings Grants) is taxable to the parent for U.S. tax purposes. There are no income tax consequences upon withdrawal of the funds. However, there is an element of double taxation. As noted, for U.S. tax purposes, the plan income will be taxable to the parent, but for Canadian tax purposes the income will generally be taxable in the hands of the child when they go to university or college.

Contributing Parent is Not a U.S. Citizen or Resident (Foreign Nongrantor Trust): The income earned within the plan is not taxable to any party when earned. However, if the child is a U.S. citizen or resident, the accumulated income is taxable to the child upon withdrawal of the funds. A special prescribed tax and interest charge is calculated based on the accumulated income distributed from the plan, which achieves roughly the same result as if the income were taxed as it was earned over the life of the RESP.

Since an RESP is a foreign trust, U.S. persons who invest in them are subject to the U.S. reporting requirements for foreign trusts. The ability to obtain the tax treatment as described above can be jeopardized if the proper U.S. tax reporting forms are not completed. In certain cases, a portion of the original RESP contributions may be taxable to the beneficiary, if the

appropriate forms are not filed. To understand the required reporting requirements, contact your BDO advisor.

If you are considering contributing to an RESP for your child in order to take advantage of the Canada Education Savings Grant, it is important to consider the consequences described above. In certain cases, it would be better for another relative in Canada (who is not a U.S. person) to set up the RESP. For example, if a U.S. person marries a Canadian and they have a child (who is not a U.S. person), contributions by the parents of the Canadian spouse could be made for a grandchild, thereby avoiding the U.S. issues.

RCA payments

RCAs are a special type of trust established by an employer for an employee's retirement. The treaty deferral provisions under the Canada-U.S. treaty for RRSPs and RRIFs again do not apply to payments out of RCAs. As a result, if a U.S. person resident in Canada receives a payment out of an RCA there may be a mismatch with respect to both the income earned in the RCA and the contributions. For U.S. purposes, the contribution will be taxed as employment income at the time the employer contributes to the RCA and income in the RCA will be taxed as it is earned. For Canadian purposes, the contribution and the accumulated income are ultimately taxable when paid out to the employee (refundable tax is charged first, but is later refunded as payments are made to the beneficiary). Of course, the timing can provide a benefit where you are present in Canada for a short period or where you are contemplating giving up Canadian residence. However, RCAs may not be advisable for U.S. persons who will not return to the U.S.

If you are considering a Canadian deferred income plan, consult with your BDO advisor to determine the tax consequences from both a U.S. and Canadian tax perspective.

U.S. Social Security

As a U.S. person resident in Canada, if you receive U.S. Social Security payments, you will effectively have to include 85% of the payments in your Canadian income tax return. However, you will not be subject to tax on this income in the U.S., as you will be able to deduct the amount by claiming a treaty exemption on your U.S. income tax return.

Investments in foreign corporations

As mentioned, U.S. persons must report their worldwide income for U.S. tax purposes. If a U.S. person invests in a foreign corporation (such as a Canadian corporation held by a U.S. citizen living in Canada), a potential deferral exists to the extent the U.S. person is not taxed until actual distributions are made by the foreign corporation. To prevent a deferral benefit on certain types of income, the U.S. has certain anti-deferral regimes in place. If you own or are considering the purchase of shares of certain types of non-U.S. corporations, you must be careful that you don't become subject to these anti-deferral regimes, which can capture foreign income earned in respect of the shares.

Two significant U.S. anti-deferral regimes include:

- ◆ Controlled Foreign Corporations (CFCs), and
- ◆ Passive Foreign Investment Companies (PFICs).

Note that a third anti-deferral regime also existed – known as Foreign Personal Holding Companies (FPHCs). However, the rules related to this regime were repealed effective for taxable years beginning January 1, 2005.

Generally speaking, if you are considering an interest in a non-U.S. corporation where more than 50% of the shares (based on votes and value) are owned by U.S. persons, or more than 75% of a corporation's income is passive income, or 50% or more of the corporation's assets are passive assets, you may be taxable for U.S. purposes under one of the two existing anti-deferral regimes. These regimes impose tax on a current basis, or on a deferred basis with an interest charge, on income earned by a U.S. person through the foreign corporation. For example, you may be required to include a portion of the passive income of the non-U.S. corporation in your taxable income in the year the income is earned by the corporation, even though you have not yet received an actual distribution from the corporation related to that passive income. This treatment can result in mismatches with the timing of Canadian tax and result in double taxation.

Another consequence under the PFIC regime (and the former FPHC regime) is that in certain situations, shares acquired by inheritance do not receive a "stepped-up basis" for U.S. tax purposes, which means that the person inherits the shares at their original cost, not at the fair market value of the shares on the date of death. Note, however, that with the repeal of the FPHC rules, a number of related issues will be eliminated where certain conditions are met.

Some Canadian estate planning for U.S. persons can put you right into the anti-deferral regime rules, especially the onerous PFIC rules. For example, although shares of an operating company may be exempt from

these rules, the use of a Canadian holding company can create passive asset holdings and significant problems.

When U.S. persons are involved in Canadian estate freezes, U.S. income tax issues can arise, as well as estate and gift tax issues (discussed below). It is important to consider all of the U.S. tax issues when U.S. persons hold Canadian corporations. There is a potential for double taxation and significant penalties for not complying with U.S. tax filing requirements if U.S. tax rules are not considered. In particular, the IRS has implemented a procedural change beginning January 1, 2009, with respect to the assessment of penalties for information reporting with respect to certain foreign corporations (Form 5471). Specifically the IRS will impose a penalty of \$10,000 for each Form 5471 that is filed after the due date of the income tax return or does not include complete and accurate information that is required.

The rules regarding U.S. persons investing in non-U.S. corporations are complex. If you are considering taking an interest in a private Canadian corporation or reorganizing an existing corporation, consult with your BDO tax advisor.

Estate tax

U.S. income tax is not the only concern for U.S. persons residing in Canada. On your death, U.S. estate tax will apply to the fair market value of your entire worldwide estate, not just those assets situated in the U.S. The estate tax is then applied at graduated rates to this amount.

In June 2001, the U.S. passed a law that phased out the estate tax by 2010. However, because of the way this legislation was enacted, the full repeal of the estate tax was only for one year - 2010. For 2011, the US estate tax was to revert to the old rules prior to this law being enacted. For years, it has been unclear if the estate tax would ultimately be repealed.

This question has now appeared to have been answered. On February 27, 2009, the new administration in the U.S. released its 2010 budget blueprint. In this document is a proposal that the estate tax, as it is in effect in 2009, will be permanently extended and indexed to inflation. If this new proposal is enacted, it will confirm that the U.S. estate tax is here to stay and that planning to mitigate the effect of this tax will continue to be a key component of tax planning.

How the estate tax applies

Estates of U.S. persons are subject to U.S. estate tax based on the fair market value of worldwide assets and are entitled to a "unified credit", which effectively exempts a portion of the estate from estate tax. For U.S. persons, the unified credit is based on an effective exemption amount of \$3.5 million U.S. for 2009, as shown in the table below. The top estate tax rate is 45%.

Other graduated rates remain unchanged. Estate tax can be reduced by a marital credit for a transfer of property to a spouse if the spouse is a U.S. citizen or, if the spouse is not a U.S. citizen, on a transfer of property to a “qualified domestic trust”.

Year	Effective Exemption (U.S. \$)	Top Estate Tax Rate
2006	2,000,000	46%
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010 and after ^[1]	3,500,000	45%

^[1]Under the new proposals, the effective exemption amounts for 2010 and subsequent years will be based on the 2009 exemption, indexed for inflation.

For 2009, the graduated estate tax rates and the unified credit are as follows:

Taxable Estate		Estate Tax	
From (U.S. \$)	To (U.S. \$)	Tax on Bottom of Range (U.S. \$)	Rate on Excess
0	10,000	0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	And over	555,800	45%
Unified Credit for 2009			\$1,455,800

Unlike the U.S., Canada does not have an estate tax. But, when Canadian residents die, they are deemed to dispose of all their capital property at fair market value, unless the property flows to a spouse. Fortunately, any U.S. estate tax that has to be paid on death may be eligible as a credit against Canadian income tax in the year of death on U.S. source gains and income. Similarly, any Canadian income taxes resulting from death may be eligible as a credit against U.S. estate tax.

U.S. income tax rules

Under current U.S. tax rules, where an asset is subject to estate tax, the heirs of the deceased generally inherit the asset with a cost base for U.S. income tax purposes equal to fair market value on the date of death (though there are exceptions to this general rule). This means that someone who inherits property will only be liable for tax on any appreciation in value that accrues while they own the property – they will not be taxed on any appreciation in value that occurred while the property was owned during the lifetime of the deceased. However, if the proposals to make the estate tax permanent are not enacted, which means that the estate tax will effectively be repealed for 2010 only, special rules for deaths in 2010 will apply regarding the cost base of property inherited on death.

Gift tax

U.S. persons are subject to gift tax on the direct or indirect transfer of property by gift. The gift tax is imposed on the donor and applies to the extent that the value of the property transferred exceeds allowable exclusions and deductions. As well, reporting requirements are generally imposed on U.S. persons who receive aggregate foreign gifts in excess of \$12,000 U.S. during the year in 2008 or 2009. Like the estate tax, the gift tax rate is decreasing each year until 2009.

As previously mentioned, an estate freeze of a Canadian corporation can result in gift tax concerns if the freeze is not properly structured. If you give or receive a gift valued at more than \$12,000 U.S. in 2008 or \$13,000 in 2009, you should discuss the consequences with your BDO tax advisor.

Foreign tax credits

Canada has become more aggressive on its taxation of worldwide income. To claim a foreign tax credit on foreign income, the income has to be subject to tax in the foreign jurisdiction (in other words, it can't be exempt in the foreign country). This will likely increase the overall tax cost of U.S. persons who are residents of Canada, since they are no longer able to “force” foreign sourced income to maximize foreign tax credit claims in Canada.

Relinquishing U.S. citizenship

Given the onerous reporting requirements the U.S. imposes on its citizens regardless of where they reside, some U.S. citizens living permanently in Canada may wonder whether it is advantageous (for tax purposes) to relinquish their U.S. citizenship. Unfortunately, there are rules in place which now allow the IRS to levy an “exit tax” and, for expatriations prior to June 17, 2008, strengthen the U.S. government's ability to tax U.S.

source income after an individual left the U.S. at the rates applicable to U.S. citizens rather than at lower tax rates that apply to non-resident aliens.

On June 17, 2008 new legislation was enacted that replaced the rules allowing the IRS to tax expatriating citizens for a 10 year period and imposed a new tax system.

New Rules

If you expatriated after June 17, 2008 you are subjected to a new "exit tax" rule. The 2008 Heroes Act introduced a "mark-to-market" tax for U.S. citizens and long-term residents who expatriated from the U.S. These provisions will apply to citizens or long-term residents (eight of the last 15 years) if you meet one of the following conditions:

- ◆ Your average annual net income tax liability for the five years preceding the date you relinquish your citizenship exceeds \$139,000 for 2008 (\$136,000 for 2007).
- ◆ Your net worth at the date you relinquish your citizenship exceeds \$2 million.
- ◆ You failed to certify under penalties of perjury that you have complied with all of your tax obligations for the preceding five years; or
- ◆ You have not given notice of your expatriation.

Under the new law, expatriating U.S. citizens and long-term residents will be deemed to have disposed of their property for fair market value on the day before expatriation and any gain on the deemed sale would be taxed without regard to any other provision in the U.S. tax code and any loss on the deemed sale would generally be taken into account to the extent otherwise provided in the code. Any net gain on the deemed sale is taxable to the extent it exceeds \$600,000 (\$1.2 million for married individuals filing a joint return, both of whom relinquish their citizenship or terminate their residence).

The deemed sale rule will apply to all property interests held by an individual on the date of expatriation but would not, in general, apply to deferred earnings accounts which would remain subject to U.S. taxation post expatriation. The rule would appear to apply to U.S. real property interests even though they will be subject to tax post expatriation. The basis in the real property will be "stepped-up" to the extent the gain was realized upon expatriation. This is a change from the original proposal.

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Old Rules

If you expatriated between June 3, 2004 and June 16, 2008 you will be subject to U.S. tax as though you continued to be a U.S. citizen if you met the conditions outlined above.

The expatriate tax would also apply if you are present in the U.S. for more than 10 days in a calendar year during the 10 years following the date you relinquish citizenship (60 days for individuals working in the U.S. for an unrelated employer). Dual citizens and minors who have had no substantial contact with the U.S. will not be subject to the rules although they will need to provide certification that they have complied with their U.S. filing obligations.

Note also that the expatriate tax will apply only if it is greater than the amount of tax that would otherwise be imposed if you are taxed as a nonresident alien.

Certain adjustments will be made to income and deductions in this calculation

Changes under the fifth protocol to the Canada-U.S. tax treaty, ratified on December 15, 2008, clarify that long-term residents returning to Canada are also subject to the expatriation tax rules described above. A long-term resident is any individual other than a U.S. citizen who is a lawful permanent resident in the United States (i.e. green card holder) in at least eight taxable years during the period of 15 taxable years ending in the year in which the residency termination occurs. An individual will not be treated as a lawful permanent resident for any taxable year if he or she is treated as a resident of Canada under the Canada-U.S. tax treaty and the individual does not waive the benefits of the treaty.

Summary

We strongly encourage all clients to comply with IRS filing requirements. It is important to remember that although you are a Canadian resident, as a U.S. citizen or Green Card holder, you continue to have U.S. tax obligations. It's to your advantage to maintain yourself in good standing for future dealings with the U.S. authorities, particularly if you plan to return to the U.S. one day.

Don't let the situations discussed above happen to you – ensure that all of your required U.S. tax obligations are met on a timely basis. Your BDO tax advisor is ready to help.