

Taxation of Canadians Living and/or Working in the United States*

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Taxation of Canadians Living and/or Working in the United States*	1
1.01 Introduction:	1
U.S. Income Taxation of Residents	1
(a) Taxation of Individuals	1
(b) Taxation of Self Employed Persons	2
(c) Partnerships, Rental Income, Trust and Royalty Income	2
(d) Taxation of Corporations	3
(e) Identification Numbers	3
(f) State Taxes	3
1.02 The Importance of Determining Residence	3
(a) U.S. Residence Rules	3
(b) Canadian Residence Rules	4
(c) Residents of Both Canada and the U.S.	5
1.03 Elimination of Double Taxation	5
(a) Canada - U.S. Income Tax Convention, 1980	5
(b) Claiming Foreign Tax Credits	5
(c) Alternative Minimum Tax	5
(d) Totalization Agreement - Social Security	6
(e) Dual Status Tax Year	6
1.04 U.S. Taxation of Residents and Non Residents	6
(a) Canadians Employed in the U.S.	7
(b) Canadian Residents Providing Self Employed Personal Services in the U.S.	8
(c) Canadians Providing Personal Services in the U.S. as Independent Contractors Through Their Own Canadian Corporation	8
(d) Per Diem Expenses While Temporarily Working Away From Home	10
1.05 Consequences of Moving	10
(a) Leaving the United States	10

(b) Leaving Canada - Canadian Taxation of Non Residents	10
1.06 U.S. Vs Canadian Estate Taxation	11
(a) Estates in Canada	11
(b) U.S. Estate Taxation of Residents and Citizens	11
(c) U.S. Estate Taxation of Nonresident Aliens	12
(d) Foreign Tax Credits for Estates	12

1.01 Introduction:

While Canada imposes income taxes on residents of Canada, the income tax system in the United States is based on either citizenship or residence. Therefore, Canadians who live or work in the United States may find themselves subject to taxation on their world income in both Canada and the U.S. The income tax system in the U.S. is administered by the Internal Revenue Service, and is considered one of the most complex systems of taxation in the world and many legal reporting and compliance requirements are considerably different from those in Canada.

Exemption from income taxation in the U.S. because of provisions contained in the Canada-United States Income Tax Convention, 1980 and the subsequent Protocols (Fifth Protocol – effective 2008 is the latest) does not result in an exemption from filing an income tax return. Failure to file U.S. income tax forms and elections in an accurate and prescribed manner and on a timely basis may result in a denial of the exemption being sought (therefore possibly resulting in double taxation if the person is also taxable in Canada), denial of otherwise deductible expenses, interest, and penalties for inaccurate, incomplete or non filed forms or returns. The sections which follow are intended to provide a very brief summary only of some of the income tax topics relevant to Canadians in the U.S. and do not constitute a complete analysis of the tax law and planning opportunities available. Accordingly, competent international tax advice should be sought prior to acting on any of the information contained herein.

U.S. Income Taxation of Residents

(a) Taxation of Individuals

Individuals who are citizens or residents of the U.S. are taxed on their income from all sources, both within and outside of the U.S. Form 1040 (U.S. Individual Income Tax Return) must be filed with the Internal Revenue Service, each year by April 15, for the prior calendar year. Unlike taxation in Canada, form 1040 may be filed either by an individual separately, or by a married couple on a joint basis. Income tax rates are graduated, and different rate schedules are used for returns with different filing status. In this way, income tax rates are adjusted to account for differences in circumstances for persons filing as single, married filing jointly, married filing separately, qualifying widow(er), or as head of household. For tax years ending after 2007, the maximum tax rates for noncorporate taxpayers' net capital gains are 15 percent on adjusted net capital gains (0 percent to the extent the taxpayer is not in the 25-percent bracket), 25 percent on unrecaptured Section 1250 gain and 28 percent on net capital gain that is not adjusted net capital gain or unrecaptured Section 1250 gain. For unmarried individuals the 2010 regular tax rates on taxable ordinary income are 10 percent through \$8,375, 15 percent through \$34,000, 25 percent through \$82,400, 28 percent through \$171,850, 33 percent through \$373,650 and 35 percent on amounts over \$373,650.

If all taxes due are paid by April 15, an application may be made for an automatic extension of the filing deadline of form 1040 to October 15, and further extensions may be available in certain circumstances. U.S. citizens (or permanent residents) living outside the U.S. (and with no U.S. source employment income) have until June 15 each year to file their returns and pay taxes, without filing an extension..

Employers in the U.S. are required to withhold the prescribed amount of federal and state tax, including social security, unemployment, and Medicare taxes. The withholding rules apply to all persons employed in the U.S., even if employed by a foreign employer, unless specific provisions exempting withholding under the Canada -U.S. Income Tax Convention (Treaty) are met and applied for on a timely basis.

Many Canadians believe that mortgage and loan interest and other deductions that are not available in Canada are available in the U.S. Although these and other deductions can be made in the U.S., persons filing U.S. tax forms must choose whether to itemize these deductions or claim the standard deduction (which was \$5,450 for a single individual, \$8,000 for head of household, \$10,900 for married filing jointly or qualified widow (er) and \$5,450 for a married filing

separately taxpayer in 2008). Therefore deductions may not be used if they do not exceed the standard deduction for that year.

U.S. residents are also required to disclose on U.S. Treasury form 90.22.1 any holdings in foreign bank and securities accounts, by June 15 of the following year.

(b) Taxation of Self Employed Persons

Persons carrying on an unincorporated business as a sole proprietor in the U.S. are subject to income tax on their gross income less allowable deductions attributable to that income, and must file Schedule C with their tax return for each business, each year. Complex rules involving the amount of investment "at risk", the degree of "material participation" in the venture, and the nature of the business are used to determine the extent of and the timing of the deduction of losses from self employment activities.

Self-employed persons are also subject to the Self Employment Tax, which amounts to 15.3% of self-employment income, and is imposed in addition to any income taxes payable. The Self Employment Tax is used to fund social security taxes, and is the equivalent of the self employed Canada Pension Plan amount payable in Canada. One half of self-employment tax is deductible from income prior to the calculation of tax liability.

Self employed persons may, depending on their income in any given year, be required to pay quarterly installments of income tax in advance for the next taxation year. The required installments are normally calculated on the basis of income reported in the current year on form 1040.

(c) Partnerships, Rental Income, Trust and Royalty Income

Although partnership income is reported on form 1040 - Schedule E each partnership operating in the U.S. must file a separate tax return each year on form 1065. The partnership distributes its income, expenses and other items to partners on form K-1.

Rental and royalty income are also disclosed on Schedule E. A U.S. resident who files Schedule E which discloses rental income from sources in Canada or elsewhere must use U.S. rules in the determination of

income and expenses, which in many cases can be significantly different from the rules used in Canada.

Whereas losses from real estate rentals are generally deductible against other income in Canada, Canadian rules prohibit the claiming of capital cost allowance (depreciation) to create or increase a loss from real estate. In the U.S., losses may be created by claiming depreciation, (and depreciation calculations are mandatory rather than elective) but the deductibility of the losses may be limited or deferred by the “passive activity loss” rules.

Net income from rental, royalty or other passive (i.e. interest, dividends, investment) activities may give rise to the requirement to pay quarterly installments of federal (and/or state) tax in advance for the next taxation year.

(d) Taxation of Corporations

Corporations carrying on business in the U.S., whether incorporated in the U.S. or elsewhere, must file a return of income each year within two and one half months after their fiscal year end, and must use variations of form 1120 depending on whether the entity is a Limited Liability Company (LLC), Subchapter S corporation or other entity. Corporations (except flow through entities) pay income tax at graduated rates starting with 15 percent to \$50,000 and with a maximum of 35% in 2009 (for taxable income under \$10 million).

Non U.S. corporations that are controlled by “U.S. persons” must be reported on form 5471 on the personal income tax returns of certain shareholders.

Corporate tax planning in the United States is considerably different than that in Canada, since rules are in place to prevent the accumulation of income in excess of \$150,000 in a corporation, planning of year end bonuses to reduce corporate income, and accruals of income to related cash basis taxpayers.

(e) Identification Numbers

Every individual who files a U.S. tax return must have a valid identification number issued by the Social Security Administration and acceptable to the IRS. For U.S. residents, citizens, and visa holders entitled to work in the U.S., a Social Security Number (SSN) is required, and is available by completing form SS-5 (Application for a Social Security Card). For spouses, dependents and non-residents who file a U.S. tax return

or are claimed as dependents on a U.S. tax return but are not permitted to work in the U.S., an Individual Taxpayer Identification Number (ITIN) is required, and is available by completing form W-7 (Application for IRS Individual Taxpayer Identification Number). The IRS will not accept tax forms without appropriate identification numbers.

Partnerships, corporations and self employed persons should apply for an Employer Identification Number (EIN) by filing form SS-4 (Application for Employer Identification Number).

(f) State Taxes

Many states in the U.S. have independent income tax systems applicable to persons living in or earning income from within the state or corporations doing business in the state. Although many states that impose an income tax use the federal taxable income as a starting point, rates, methods of taxation, rules of computation and filing requirements vary from state to state and from entity to entity.

Many states do not recognize foreign tax credits for taxes paid to foreign countries or provinces. As a result, proper tax planning should be undertaken prior to establishing residence in a state to take into account the implications of state taxation as it is complicated by federal and international taxation.

1.02 The Importance of Determining Residence

Since both Canada and the U.S. impose an income tax on residents based upon their world income and since both countries have income tax laws dealing with the taxation of non residents, it is important to understand the role that residence plays in determining the liability for income tax.

(a) U.S. Residence Rules

(i) Green Card Test

Under U.S. law, persons who satisfy the “green card test”, including anyone who holds a permanent resident visa and others who reside permanently in the U.S. are considered taxable in the U.S. on their world income from the day they obtain their permanent resident status. Green card holders may therefore find themselves or their business interests subject to U.S. tax rules, even if the business activities or controlled business entities are

outside the U.S., and foreign corporations may be subject to the Accumulated Earnings Tax, or Personal Holding Company Tax rules in the U.S. due to differences in the income tax planning, distribution.

(ii) Substantial Presence Test

A person who has not established a residence in but who spends a considerable amount of time in the U.S. may find that they are considered residents of the U.S. even if they do not spend 183 days or more in the U.S. in any given tax year. The time required to meet the substantial presence test is 183 days, counting all of the days in the current year, one third of the days in the first preceding year, and one sixth of the days in the second preceding year.

Year	Days Present	Portion Counted	Days Included
2011	130	1/1	130
2010	126	1/3	42
2009	72	1/6	12
Total			184

Table 1 – Substantial Presence Test

The person whose situation is illustrated in Table 1 meets the substantial presence test, but may apply for exception from the substantial presence test rule by filing form 8840 (Closer Connection Exception Statement) to prove that they have closer ties to Canada than to the U.S. In order to qualify for exception, the Canadian resident must be able to establish that the usual indicators of residence (i.e. drivers license, club and religious affiliation, income, etc.) indicate stronger ties to Canada than to the U.S.

Many Canadians file form 8840 by itself with the IRS in Philadelphia as a protective measure each year, and Canadians who have U.S. source income and are required to file form 1040 NR file form 8840 along with the form 1040 NR.

(b) Canadian Residence Rules:

(i) Residents of Canada

Surprisingly, there is no specific definition of residence in the Canadian Income Tax Act, but residence is determined as a question of fact. Primarily, any person who spends more than 183 days in any year in Canada is considered a resident. In other cases the court system in Canada has held that the residence of an individual is the place where he customarily lives. In determining

residence, such factors as the following are taken into account:

- Permanence and purpose of being outside Canada. Generally, absences of less than two years are not considered sufficiently permanent to sever residential ties with Canada for tax purposes.
- Residential ties in Canada, including the maintenance of a home, location of dependents, investments, bank accounts, health coverage, drivers license, club memberships, professional memberships dependent on residence, personal property, vehicles, social ties, telephone listings, etc.
- Residential ties abroad, including visa status outside Canada, income, occupation and social ties. If a Canadian has not established a domicile in another country, he may be considered to have maintained Canadian residence. The type and duration of visas have a role in this factor.
- Regularity and length of visits to Canada, can establish continued residence in Canada.

Although visa status in the U.S. by itself will not determine Canadian residence, and even though immigration rules and income tax rules do not always maintain the same definitions of terms, care should be taken not to upset immigration status through an improperly planned elimination of residential ties to Canada. For example, persons working in the U.S. under the NAFTA TN visa are expected to be temporary residents of the U.S. An inability to prove an intention to return to Canada upon the expiry of the visa may affect the determination of visa status or renewal.

(ii) Deemed Residents of Canada

Persons who have sojourned in Canada for 183 days or more in any year are deemed to be residents of Canada, and must report world income on their Canadian income tax return for the year. In the year of departure from Canada, both spouses are deemed to be resident in Canada until the date of the latter of the two to depart. Care should therefore be taken to ensure that unplanned periods of tax residence in Canada are not encountered.

(iii) Deemed Non Residents of Canada

Under new interpretations of the tiebreaker rule contained in the Treaty, certain persons, after February 25, 1998, are deemed non-residents of Canada if they maintain closer connections to a country other than Canada. Persons in this category would pay tax to Canada only on Canadian source income regardless of the amount of time they spend in Canada.

(c) Residents of Both Canada and the U.S.

Many individuals may find themselves residents of both Canada and the U.S. as a result of the application of the above rules. Under dual residence circumstances, double taxation can be eliminated if filings are made on a timely and accurate basis, as described in the following section.

1.03 Elimination of Double Taxation

(a) Canada - U.S. Income Tax Convention, 1980

Article XXIV of the Canada - U.S. Income Tax Convention, 1980 (Treaty) sets out the rules for foreign tax credits which are available in circumstances where each country claims a right to tax the same income. The Treaty also deals with the treatment to be applied to specific types of income, specific occupations or business endeavors, the determination of residence, and withholding taxes.

By invoking protection under the Treaty, an individual or company claims special exception from taxation under the specific tax laws in either Canada or the U.S. because of a potential for double taxation.

Essentially, the Treaty provides that taxpayers be taxed in their country of permanent residence, unless they have a “permanent establishment” or “fixed base” available to them in the other country. A “permanent establishment” or a “fixed base” has been defined to be an office, a permanent residence, or can be established through the use of an agent who has authority to bind the taxpayer. Under certain circumstances, such as where a part year resident of the U.S. elects to be taxed as a U.S. resident for the entire year, Treaty protection is not available.

It is also important not to claim Treaty protection from U.S. taxation on the basis of residence in situations where a Canadian has obtained permanent resident status in the U.S., since such a statement is inconsistent with and may invalidate the U.S. visa status.

Residents of both Canada and the U.S. may find that their overall income tax liability in any year is not affected by a requirement to file and pay U.S. income taxes, since the operation of the foreign tax credit allows a deduction from Canadian tax to the extent that the same income has been taxed in the U.S.

Canadians who work in the U.S. and are exempt by Treaty from U.S. taxation may apply for exemption from withholding of income and other taxes in the U.S., but must have taxes withheld if their income, time present in the U.S., residence of their employer, or other factors disqualify them from Treaty protection.

(b) Claiming Foreign Tax Credits

Where a resident of Canada is taxed on income earned in the U.S., a claim may be made on the Canadian T1 return for relief from Canadian taxation, but only to the extent that tax was paid on that specific income, and only to the extent of the tax actually paid or payable to the U.S., as limited to the Canadian tax which would be otherwise payable on the same income.

For example, a Canadian resident who files a U.S. 1040 NR return upon which U.S. source employment income was declared, would include the gross amount of the employment income, convert the income to Canadian dollars, and calculate tax on the result. The foreign tax available for credit against the Canadian tax calculated, would be the actual amount of the tax accrued for that employment income after taking into account deductions for all deductible items in the U.S. (Under new rules set out in the Fifth Protocol to the Treaty, ratified on December 15, 2008, deductions for contributions to U.S. pension plans would be also deductible in Canada if other conditions for pension deductibility are met in Canada.) Canadians who move to the U.S. may find that they have paid tax on Canadian source income including rental income in Canada, and must include the rental or other income in their U.S. form 1040 and file form 1116 (Foreign Tax Credit) to claim a foreign tax credit. Under these circumstances, the credit available is restricted to the actual amount of tax paid or accrued on each specific category of income. Foreign income taxes that cannot be used in any year can be used in respect of the same category of income in future periods for a limited time.

(c) Alternative Minimum Tax

The operation of the Alternative Minimum Tax (AMT) rules may sometimes limit the benefit of items otherwise deductible. Under AMT all income items and deductions are re-calculated using AMT rules, and a separate tax rate is applied, subject to the AMT deduction. The tax actually payable in any year is the higher of the tax calculated under the regular rules, and that calculated under the AMT rules. Although the rules for AMT calculation differ in the U.S. and

Canada, they operate in a similar manner, and can give rise to a tax liability where no tax would otherwise be payable.

(d) Totalization Agreement - Social Security

An international agreement respecting social security between Canada and the U.S. sets out the rules for social security taxation for residents of one country working in the other. This agreement, also known as the Totalization Agreement, provides that a Canadian working in the U.S. on a temporary assignment (of up to 5 years) for a Canadian company is exempt from U.S. social security taxes if he remains covered by the Canada Pension Plan (CPP).

In order to prove coverage under the CPP, form CPT 56 must be completed and certified by Revenue Canada. This certified form then acts as the authority not to withhold and remit U.S. social security taxes at source from employment income. A similar exemption is available to self employed Canadian residents who work temporarily in the U.S. (Reciprocal rules are available for U.S. residents working for U.S. companies temporarily in Canada.)

However, Canadian residents employed by U.S. companies in the U.S. are not eligible for relief under the Totalization Agreement. Caution should therefore be used in the transfer of employees to the U.S. to ensure that the transferees remain residents of Canada, and continue to be engaged by the Canadian company (or its subsidiary), since a person would not be covered under the CPP where he/she was considered to be "an employee engaged locally outside Canada".

Even though all U.S. social security taxes are available as a foreign tax credit to Canadian residents working in the U.S. – resulting in no overall increase in tax to the employee, the benefits of the Totalization agreement are:

If the employee were engaged in the U.S. for 5 years in total, he/she would not be eligible for U.S. social security benefits (since 10 years service are required) – resulting in wasted contributions.

While the employee is working temporarily in the U.S., Canada Pension Plan premiums will continue to be made, and will count toward eventual CPP benefits;

The overall cost to the employer is less, since the 2009 employer portion of U.S. social security taxes is 6.2% of the first \$US106,000 (plus medicare tax of 1.45%

without limit), while the employer portion of CPP is 4.95% of \$CDN 41,400, or \$C 4,098.60.

(e) Dual Status Tax Year

A non U.S. citizen who moves into or out of the U.S. in a year, is considered a "dual status alien", and is taxed for that year as if the tax year consisted of two periods, one for the time of residence and the other for the nonresident period. Although the income tax liability for the period that the individual is a nonresident alien is determined under the rules relating to nonresident aliens, the taxable income for the year that is subject to the regular graduated tax is determined by combining all income for the period of U.S. residency with any income for the nonresidency period that is effectively connected with the conduct of a U.S. trade or business.

A dual status individual is generally entitled to one personal exemption, except that a resident of Canada may claim exemptions for the nonresident period for a spouse and children. However, a dual status alien cannot claim the standard deduction, but must itemize deductions on his income tax return.

The above rules will not apply in cases where a Canadian moves to the U.S. in a tax year, is married to an individual who is a U.S. resident at the end of the year, (i.e., a Canadian spouse moving with him will qualify) and both elect under IRC 6013(g) or (h) to be treated as U.S. residents for the entire year. An alien who moves to the United States too late in the year to meet the substantial presence test may also elect to be a resident for part of that year, if he/she meets certain conditions in IRC 7701(b) and is present in the U.S. for at least 31 days in the year.

Under certain circumstances, this election can be beneficial, and calculations contemplating the effect of the election should be made in the preparation of the dual status tax return to determine the optimal treatment. Persons making this election cannot claim any benefit under any foreign tax Treaty which the U.S. is party to.

1.04 U.S. Taxation of Residents and Non Residents

Due to the wide range of alternatives available to Canadian residents who conduct business in the U.S., this discussion has been restricted to the provision of personal services by Canadians in the U.S. only.

Non-residents who are taxable in the U.S. on their U.S. source income must file form 1040 NR by June 15 each year for the prior calendar year. Married residents of Canada may claim exemptions for a spouse and dependent children who lived with them. Although the maximum tax rate used on the form 1040 NR is the same as that for form 1040, fewer deductions and exemptions are generally available, resulting in a higher overall federal tax cost. Non residents filing form 1040 NR cannot claim the standard deduction, but must itemize deductions.

(a) Canadians Employed in the U.S.

A resident of Canada who is employed by a Canadian company in the U.S falls under the Canada U.S. Income Tax Convention (Treaty) - Article XV - "Dependent Personal Services", which states:

"Subject to the provisions of Articles XVIII (Pensions and Annuities) and XIX (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State."

This has been defined to mean that employment income is exempt from U.S. taxation and withholding unless it is over \$10,000 per year. If it is over \$10,000 per year, it is exempt only if:

The individual was in the U.S. less than 183 days in any calendar year, and

The cost is not borne by (deductible by) a U.S. resident employer or an employer with a fixed base in the U.S.

Therefore, to be exempt under the Treaty, an individual must be employed in the U.S. by a Canadian corporation without a fixed base in the U.S. Employment in the U.S. by U.S. employers, and Canadian employers with a permanent establishment or fixed base in the U.S. is fully taxable in the U.S.

A Canadian employer with a fixed base in the U.S. who hires or transfers Canadian residents to work in the U.S. should ensure that U.S. withholding taxes are deducted and remitted to the U.S., and that withholdings to Revenue Canada are eliminated, except for those required to fund Canada Pension Plan (under the Totalization Agreement). Failure to do so can create a cash flow problem for the employee, since they will be taxable in the U.S. and will have to pay U.S. taxes

before the Canadian withholdings are recovered through the operation of the foreign tax credit.

Although persons employed by U.S. resident employers and foreign employers with a U.S. fixed base are subject to tax withholding at source on U.S. source income, and are liable to file form 1040 NR to disclose that income, the overall tax cost to the individual will not necessarily be increased as a result of the operation of the foreign tax credit available in Canada for the taxes paid to the U.S. or a state.

A person who is exempt from U.S. taxation under the Treaty must still file:

- **U.S. 1040 NR Nonresident Alien Individual tax return** - this return would not include any income, but would be filed to preserve the Treaty based exemption from taxation.
- **Form 8833 - Disclosure of Treaty Based Position** - disclosing the basis for exclusion of income. Law requires this, with severe penalties for failure to disclose a Treaty based position.
- **Form 8840 - Closer Connection Exemption** - to prevent taxation of world income in the United States by virtue of presence in the U.S. - through the establishment of a closer connection to Canada;
- **U.S. Form 8233 Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual** - to prevent withholding of income tax at source on employment income from U.S. sources.
- **Canadian T-1 Individual Income Tax Return** - including world income and the employment income earned in the United States;

Failure to file may result in a fine, and potential denial of the Treaty exemption.

Persons who fail to file the Treaty based disclosure returns on the presumption that they are not taxable in the U.S. also risk having tax assessed in the U.S. at a later date when the Canadian return is barred from adjustment as a result of the time statute to include the additional tax under the foreign tax credit provisions in Canada - thus resulting in potential double taxation. It is therefore extremely important to comply with the letter of the law when it applies to the filing of tax returns, even if there is no apparent immediate tax liability.

(b) Canadian Residents Providing Self Employed Personal Services in the U.S.

A Canadian resident providing personal services in the U.S. as a self-employed individual formerly fell under the Canada U.S. Income Tax Convention (Treaty) -- Article XIV - "Independent Personal Services", which exempted self employment income from taxation in the U.S. regardless of amount or time spent in the U.S. as long as no permanent establishment was maintained in the U.S. Effective January 1, 2008, Treaty Article XIV has been eliminated, and instead replaced by the following in the Fifth Protocol:

Permanent Establishment Defined:

The definition of "permanent establishment" was subject to much interpretation in the former Treaty. Under the new rules, the application of benefits in many cases is tied to whether a person or company has a permanent establishment in a contracting state. A permanent establishment is now created where an individual spends more than 183 days in the other state and during that time more than 50% of the gross revenue generated by the business is derived from services rendered in the other state by that individual. A permanent establishment may also be created where services are provided in the other state for more than 183 days in any 12 month period with respect to a project for a resident of the other state.

Proportional Taxation:

Consistent with changes in the definition of "permanent establishment" mentioned above, the blanket exemption from taxation available to individuals or businesses providing business services in the other state (but not through a permanent establishment) has been repealed. Now, "business profits" are taxable in each state on a basis proportional to the activity carried out through a permanent establishment in each state.

Assuming that the individual is not deemed to have a permanent establishment in the U.S. under the new definition, the following filings may be required each year:

- **U.S. 1040 NR Nonresident Alien Individual tax return** - this return would not include any income, but would be filed to preserve the Treaty based exemption from taxation.
- **Form 8833 - Disclosure of Treaty Based Position** - disclosing the basis for exclusion of

income. Law requires this, with severe penalties for failure to disclose a Treaty based position.

- **Form 8840 - Closer Connection Exemption** - to prevent taxation of world income in the United States by virtue of presence in the U.S. - through the establishment of a closer connection to Canada;
- **U.S. Form 8233 Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual** - to prevent withholding of income tax at source on self employment income from U.S. sources.
- **Canadian T-1 Individual Income Tax Return** - including world income and the self employment income earned in the United States;
- **Canadian form CPT56 - Application for Certification of Coverage of Employment under the Canada Pension Plan Pursuant to Article V of the Agreement on Social Security between Canada and the United States.** - to prevent the requirement to deduct and pay social security taxes in the United States.

If, however, the individual does have a permanent establishment in the U.S. under the new definition, the following forms will be required each year:

- **U.S. 1040 NR Nonresident Alien Individual tax return** - this return would include income and expenses associated with the U.S. permanent establishment.
- **Canadian T-1 Individual Income Tax Return** - including world income and the self employment income earned in the United States;
- **Canadian form CPT56 - Application for Certification of Coverage of Employment under the Canada Pension Plan Pursuant to Article V of the Agreement on Social Security between Canada and the United States.** - to prevent the requirement to deduct and pay social security taxes in the United States.

(c) Canadians Providing Personal Services in the U.S. as

Independent Contractors Through Their Own Canadian Corporation

Canadian residents may use a Canadian corporation to derive income from personal services in the U.S. In such a case the individual would fall under Treaty Article XV (Dependent Personal Services) for the time spent providing services in the U.S. The Canadian corporation would be proportionally taxable in the U.S. if it has a permanent establishment as defined in the Fifth Protocol to the Treaty.

If the individual has no other dealings in the U.S., the individual employed by his own corporation may fall under Treaty Article XV (Dependent Personal Services) if the time and income threshold amounts are met. Assuming the individual is not exempt under Treaty the following filings may be required each year:

a) Personal Filings:

- **U.S. 1040 Individual tax return** (Including world income if factual or elected residence is established in the U.S; A separate state return is also required;
- **Canadian T-1 Individual Income Tax Return**- including world income and a foreign tax credit for taxes on the 1040;
- **Form 5471 Information Return of US Persons with Respect to Certain Foreign Corporations:** Any person who is or becomes a U.S. person by virtue of residence, who operates a foreign corporation, must disclose and include in income all passive and personal services income not derived from the country of incorporation – Subpart F. Income.

Any US person (including someone who becomes a US person during the year) must include in current taxable personal income on his 1040, his distributive share of Subpart F income earned by a foreign controlled corporation during the year on form 5471 whether distributed or not (subject to some deductions for qualifying deficits) pursuant to IRC Sec 951. Subpart F income includes income of the foreign corporation which relates to passive activities like rents, interest and dividends (unless part of active business), services rendered outside the foreign country, foreign personal holding company income, sales commissions earned for sales outside of the foreign country.

This law includes personal service income of US persons, which has been channeled through a foreign country in their personal corporation. Therefore, a Canadian who goes to the US to work providing

personal services in the US through a Canadian corporation he/she controls, and becomes a US person by virtue of residence, would be liable to include all net service income in his/her US return which is earned by the Canadian corporation, whether distributed or not. To further complicate matters under US rules (IRC267), Canadian style accruals of management bonuses are not permitted to cash basis related parties, and all “bonus” amounts must be paid within the tax year increasing the complexity of tax planning for corporations operating in the U.S.

b) Corporate Filings:

- **U.S. Form 1120-F U.S. Income Tax Return of a Foreign Corporation** – The corporation would file details of income and expenses related to the U.S. component of operations on a “proportional” basis.
- **U.S. Form W-2 & W-3 – Wage & Tax Statement and Summary** Remittances of tax should be made if the expected stay in the U.S. is over 183 days in the year or if more than \$10,000 is paid (otherwise forms 1042 & 1042S are filed).
- **U.S. Form 5472 - Information Return for 25% Foreign Owned Corporation and Related Party Transactions** - to disclose dealings with the Canadian shareholder.
- **Canadian T-2 Corporation Income Tax Return** – Foreign tax credits may need to be applied at the corporate level if all U.S. source income is not disbursed as salary.
- **Canadian form CPT56 - Application for Certification of Coverage of Employment under the Canada Pension Plan Pursuant to Article V of the Agreement on Social Security between Canada and the United States.** - to prevent the requirement to deduct and pay social security taxes in the United States.

Canadians who operate a small business corporation that would otherwise be eligible for the “Small Business Deduction” under Para. 125 of the Income Tax Act (Canada) should be cautioned that in order to be eligible for the low corporate rate of tax on Canadian Controlled Private Corporations, the corporation must be engaged in an active business carried on in Canada. Income from personal services rendered by the majority shareholder in the U.S. and paid to the corporation will not be eligible for the lower Canadian corporate rate of tax..

(d) Per Diem Expenses While Temporarily Working Away From Home

Canadians who work temporarily in the U.S., and are away from home for business purposes may be eligible to claim a deduction from U.S. taxes for the costs of lodging, food and travel incident to their engagement. For U.S. purposes, per diem and expense reimbursement plans fall into two categories:

- **Accountable Plans** - in which the employee accounts for each specific expense and returns the balance. These are not taxable, not includable in a W-2, and not subject to FICA, FUTA, etc.; and
- **Non-Accountable Plans** - which are included on the W-2, but for which the employee can claim itemized deductions subject to the 2% of AGI deduction on Schedule A.

If an expense reimbursement is less than the rate prescribed by the IRS (in tables provided for that purpose) for the area in which the individual works, it will automatically be classified as an accountable plan reimbursement, and will not be taxable.

1.05 Consequences of Moving

(a) Leaving the United States

Non U.S. citizens leaving the U.S. during a year and wishing to report their anticipated annual income during the year may file form 1040-C - U.S. Departing Alien Income Tax Return. The 1040-C is not a final return, and a 1040 or 1040NR must still be filed within the required time limits. A non U.S. citizen who leaves the United States will normally have a dual status tax year in the year of departure.

(b) Leaving Canada - Canadian Taxation of Non Residents

Persons who are not residents of Canada are taxable in Canada on income from Canadian sources.

(i) Consequences of Leaving Canada

Canadians who give up residence in the year are deemed to have disposed of all of their capital properties at fair market value at the time of departure from Canada, giving rise to deemed capital gains or

losses that are reportable in the year of departure. "Taxable Canadian Property" such as Canadian real estate or shares of non-listed corporations, resource property, and trusts is not deemed to be disposed of on departure, but is subject to non resident withholding tax, and filing requirements upon eventual disposition.

Deemed dispositions of capital property which are not actually disposed of while absent from Canada, may be reversed if the individual returns to Canada as a resident within five years of departure.

Individuals permanently moving to the U.S. should consider disposing of capital property prior to establishing U.S. residence, since unlike Canadian rules, the U.S. will impose a tax on any capital gain based on original cost, from a disposition of capital property by a resident. No provision is made for revaluing the capital property at the time of entry to the U.S., unlike under Canadian capital gains rules.

(ii) Rental Real Estate in Canada

A non-resident who receives Canadian rental income may file a Sec. 216 return to report the rental property under Part I, rather than being taxed under Part XIII (withholding taxes - non residents). Form NR6 is used to undertake to file a Sec. 216 return and to reduce withholding requirements to actual expected profits (rather than gross rents). Even though no personal exemptions may be claimed on such a tax return, an RRSP deduction may be made to the extent a contribution is made within available room. The effect of Para 216 on net income is usually beneficial.

(iii) Registered Retirement Savings Plans

No rollovers of Canadian RRSP's are feasible to U.S. IRA's or similar plans (or visa versa), since such a transfer would be considered a distribution under Canadian law. Accordingly, persons moving to the U.S. after a work period in Canada should consider leaving the RRSP intact, and drawing funds from the plan only upon retirement or as provided for under Canadian law.

Upon withdrawal by non-residents, RRSP funds will be subject to a 25% non-resident withholding tax and a non-resident may improve that tax by electing to file a return under Sec. 217, which taxes RRSP income but considers world income.

For U.S. tax purposes, RRSP withdrawals are taxable only to the extent that income (and not contributed principal) was withdrawn from the plan. Income earned within the plan while not a U.S. resident or citizen will also not be taxable for U.S. purposes except for state purposes in California. U.S. residents who hold Canadian RRSP accounts are taxable in the U.S. on a current basis for any income earned within the RRSP plan unless an election on form 8891 is made in each year. This election is available only for principal that was contributed while the taxpayer was a resident of Canada.

(iv) Other Income

Part XIII of the Income Tax (Canada) imposes a withholding tax on various forms of income from Canadian sources earned by non-residents.

(v) Roth IRA's in Canada

Under provisions of the Fifth Protocol to the Convention, a Roth IRA is considered a "pension" for the purposes of Article XVIII(3)(b) as long as no contributions are made to the plan while a resident of Canada after December 31, 2008. Rollover contributions made while a resident of Canada are not included in "Canadian Contributions".

To ensure that income earned within a Roth IRA is deferred and considered a "pension" under Article XVIII of the Convention, an election must be made by April 30 after the year a person becomes or is considered a resident of Canada. Income earned after the date of a "Canadian Contribution", based on the contributions made while a resident of Canada will be considered taxable in Canada in the year earned.

1.06 U.S. Vs Canadian Estate Taxation

The U.S. and Canada have considerably different systems of taxation related to the estates of deceased persons.

(a) Estates in Canada

For Canadian purposes, a Canadian resident, is deemed to have disposed of all property owned at the date of death at fair market value, thus triggering capital gains tax on any unrealized capital gains. Tax deferred items, such as RRSP's are deemed to be disposed of at the same time, subject to certain rollovers available to the

spouse of the deceased. The executor is permitted to file up to four separate income tax returns for the same decedent for the year of death for four separate classifications of income. The beneficiaries of the estate receive the property with a tax value equal to the fair market value used by the estate on the deemed disposition, and there is no system of estate taxation.

(b) U.S. Estate Taxation of Residents and Citizens

The Economic Growth and Tax Relief Reconciliation Act of 2001 has effectively repealed the estate tax.

In the U.S., although estate tax is based on the value of the estate at the date of death (or the alternative valuation date which can be up to 6 months after the date of death), the estate tax in the period before elimination of the tax is subject to tax at rates ranging from 18 to 50%.

Gift tax is levied on persons who transfer portions of their otherwise taxable estate to beneficiaries, by way of gift. Gift taxes for gifts made after 1976, but before January 1, 2010, are computed by applying the unified transfer rate schedule to cumulative lifetime taxable transfers and subtracting the taxes paid for prior taxable periods. Taxable gifts made after December 31, 2009, are taxed with reference to a separate gift tax rate schedule. For 2009, there is an annual exclusion of \$13,000 per donee for gifts.

Each U.S. citizen or resident taxpayer is allowed an exemption against the gift and estate tax. The exemption amount shields a total transfer of \$2 million from tax in 2008. This exemption amount will gradually increase to eliminate estate taxation by year 2010. The exemption amount will increase as it is phased in according to the following schedule:

- \$2 Million in 2006 through 2008
- \$3.5 Million in 2009
- Estate tax repealed in 2010

The estate tax system is designed to defer the major tax cost until the second of a married couple die, since transfers to a U.S. spouse are exempt from estate taxation (by the application of the marital credit). Qualified trusts are also used to plan an orderly taxation of estates. Severe complications may result in cases where a U.S. citizen is married to a non resident alien, since the U.S. citizen's estate may be increased by a bequest from a non resident alien spouse. Specialized

planning including the use of trusts is recommended in such cases.

The beneficiary of an estate receives property at the fair market value used in the estate valuation, notwithstanding that no capital gains tax was paid by the estate on the value of the assets.

(c) U.S. Estate Taxation of Nonresident Aliens

Prior to 1988 non-resident aliens of the U.S. were subject to estate taxation only on U.S. situs assets subject to a reduction of \$60,000, but at tax rates that ranged from 6% to 18%, thus resulting in a tax rate more favorable than for U.S. citizens and residents.

The revised Protocol signed on March 17, 1995 attempts to harmonize the two tax systems, since it taxes only U.S. situs assets, and permits the full reduction, pro rated on the basis of U.S. situs assets to worldwide assets. In international estates, the marital credit is calculated as the lower of the unified credit or the amount of U.S. estate tax which would otherwise be payable on the transfer of the property to the spouse.

(d) Foreign Tax Credits for Estates

Since the basis of taxation of estates is different in Canada and the United States, no foreign tax credit is permitted. However, Canadian capital gains taxes resulting from deemed dispositions on death are deductible from the gross estate for U.S. purposes.

This summary has been designed to provide a concise overview of the subjects addressed, and may not be complete. Reference should be made to original legislation prior to acting on any matter, and professional advice should also be obtained.

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