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I. Taxation of U.S. Citizens Living and/or Working in Canada*

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1.01 Introduction:

Taxation in the United States is based on either citizenship or residence, while Canada imposes income taxes only on residents of Canada. Therefore, U.S. citizens who live or work in Canada 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. While some similar regulations exist, many legal reporting, compliance and filing requirements Canada are considerably different from U.S. rules, and, in many cases, U.S. rules must be applied even to non U.S. entities controlled by U.S. citizens.

Even though a person may be exempt from income taxation in the U.S. as a result of provisions contained in the Canada-United States Income Tax Convention, 1980 and the subsequent Protocols or other exemptions, in many cases an income tax return or other forms may still have to be filed to establish the exemption being claimed. 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. Therefore, in situations where a U.S. citizen intends to live or work in Canada, obtain any Canadian work permit, conduct a business in Canada, own Canadian investments or real estate, or even vacation in Canada for extended periods,

experienced tax advisors should be consulted prior to the commencement of Canadian activities.

The sections which follow are intended to provide a very brief summary only of some of the U.S. income tax topics relevant to Americans living or working in Canada 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.

1.02 U.S. Income Taxation of Citizens

(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 2008 regular tax rates on taxable ordinary income are 10 percent through $8,025, 15 percent through $32,550, 25 percent through $78,850, 28 percent through $164,550, 33 percent through $357,700 and 35 percent on amounts over $357,700.

Generally, a U.S. citizen living anywhere in the world, must file a return if the minimum income indicated for the filing status below is met in 2008:

Filing Status	Amount
Single ....………	$ 8,750
65 or older.................…………...	$ 10,050
Head of household.......………	$ 11,250
65 or older ....………..	$12,550
Qualifying widow(er) ....………	$ 14,100
65 or older ....………..	$15,150
Married filing jointly ...……….	$17,500
Not living with spouse …………	$ 3,200
One spouse 65 or older...………	$18,550
Both spouses 65 or older……….	$19,600
Married filing separately ……….	$ 3,400

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..
U.S. citizens are also required to disclose on U.S. Treasury form 90.22.1 any holdings in foreign bank and securities accounts.

(b) Taxes and Passports

Failure to file and pay U.S. taxes when due may result in a denial of a U.S. passport renewal.

(c) Americans Employed in Canada

A resident of the U.S. who is employed by a U.S. company in Canada 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 Canadian 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 Canada less than 183 days in any calendar year, and
The cost is not borne by (deductible by) a Canadian. resident employer or an employer with a fixed base in Canada.

Therefore, to be exempt under the Treaty, an individual must be employed in Canada. by a U.S. corporation

without a fixed base in Canada. Employment in Canada by Canadian. employers, and U.S. employers with a permanent establishment or fixed base in the Canada. is fully taxable in Canada.

A U.S. employer with a fixed base in Canada who hires or transfers U.S. residents to work in Canada should ensure that Canadian withholding taxes are deducted and remitted to Canada, and that withholdings to the IRS are eliminated, except for those required to fund social security and medicare taxes (under the Totalization Agreement). Failure to do so can create a cash flow problem for the employee, since they will be taxable in Canada and will have to pay Canadian taxes before the U.S. withholdings are recovered through the operation of the foreign tax credit.

(d) Self Employed U.S. Citizens Abroad

Persons carrying on an unincorporated business as a sole proprietor or disregarded entity (such as a single member LLC, for example) in the U.S. are generally subject to income tax on their gross income less allowable deductions attributable to that income, and must file Schedule C with their form 1040 for each business, each year. 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.

Generally, under the terms of Binational Social Security Agreements (or Totalization Agreements), self employed persons who are subject to dual taxation are only required to pay social security taxes or their equivalent in the country in which they reside. Accordingly, U.S. citizens resident in Canada are required to pay Canada Pension Plan (CPP) premiums and are therefore exempt from Self Employment Tax.

A U.S. citizen providing personal services in Canada. 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 Canada regardless of amount or time spent in Canada as long as no permanent establishment was maintained in Canada. 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.

This now means that any self U.S. employed individual or corporate entity which meets the above definition of “permanent establishment” will not be exempt from taxation but will be proportionally taxable in Canada on the net income earned while conducting business in Canada.

(e) Election to Treat Non Resident Alien Spouse as U.S. Resident

In general, a person who is a nonresident alien at the end of the tax year and who is married to a U.S. citizen or resident may elect to be treated as a U.S. resident for income tax purposes, if both spouses so elect.

As a result of the election:

- you and your nonresident alien spouse agree to be subject to tax on your worldwide income;
- you may claim a personal exemption for your spouse;

- you may claim deductions for items that were paid by your spouse which would not otherwise be deductible by you if you filed a separate income tax return;
- your income would be subject to tax at the rates for married taxpayers who file joint returns;
- any exempt income of your nonresident alien spouse from a public international organization remains tax exempt;
- your nonresident alien spouse may not, for U.S. income tax purposes, claim the benefits from any U.S. income tax treaty.

The decision to make this election depends on your income, both U.S. and foreign, and normally requires that at least two alternative tax filing situations be prepared to determine whether the election should be made.

(f) Identification Numbers

Commencing with the 1996 taxation year, every individual who files a U.S. income 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). This form may be sent to IRS in Philadelphia together with original identification for each applicant, or may be accepted by a Certifying Acceptance Agent. Tax forms which do not have the appropriate identification numbers will not be accepted by the IRS, and claims for dependents without appropriate numbers will be disallowed.

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

(g) Reports of Foreign Bank Accounts – 90.22.1

Each year by June 30, U.S. persons who held an interest in any foreign bank account must file form TDF 90.22.1 with the Department of the Treasury in Detroit, MI. This form details the bank accounts and discloses the maximum balance held in each account at any time in the year.

1.03 The Importance of Determining Residence

Since Canada imposes an income tax on residents based upon their world income earned within and outside Canada, and since Canada has income tax laws dealing with the taxation of the activities of non residents, it is important to understand the role that residence plays in determining the liability for income tax.

(a) 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.

Residents of Canada 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 which 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. For U.S. citizens who have migrated to Canada, a similar valuation of capital property was deemed to have occurred at the time of entry into Canada. Accordingly, only the difference between the fair market value of capital properties owned (anywhere in the world) when leaving Canada as compared to the fair market value of capital properties owned when entering Canada is used in the capital gains calculation upon departure.

(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, unless both spouses immigrated to Canada. 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 tie breaker rule contained in the Treaty, certain persons, after February 25, 1998, are deemed to be 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.

(b) 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 residence rules of Canada and the U.S. Under these circumstances, the individual is taxable on world income in each jurisdiction, and careful planning must be undertaken to apply the tax laws of both countries in the appropriate order and in a proper manner. Failure to fully understand the special needs and obligations of dual residents can result in adverse income tax treatment in either or both jurisdictions, including the imposition of penalties and interest.

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.

1.04 Elimination of Double Taxation

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

Article XXIV of the Canada - U.S. Income Tax Convention, 1980 sets out the rules related to 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. as a result of a potential for double taxation.

Essentially, the Treaty provides that taxpayers, (with the exception of U.S. citizens in some cases), 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. A resident of the United States, therefore will generally be taxable in the U.S. only, unless he has a permanent establishment available to him in Canada, and then will only be taxable in Canada on income associated with that permanent establishment. Under certain circumstances, such as where a part year resident of the U.S., or a spouse of a U.S. citizen elects to be taxed as a U.S. resident for the entire year, Treaty protection is not available.

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.

U.S. citizens and residents who work in Canada and are exempt by Treaty from Canadian taxation may apply for exemption from withholding of income and other taxes in Canada, but must have taxes withheld if

their income, time present in Canada or other factors disqualify them from Treaty protection. Although the Treaty deals with a wide variety of topics, many issues have been left unresolved, and the courts have, in the fullness of time, made pronouncements and have further interpreted its provisions.

(b) Claiming Foreign Tax Credits

Income taxes paid by U.S. citizens to foreign countries may either be deducted from income taxable in the U.S., or claimed as a credit on form 1116. Although generally it is more advantageous for U.S. citizens living in Canada to claim the credit, an amended return may be filed within 10 years if you change your mind.

In order to claim a foreign tax credit, the tax paid on each separate class of income, and for each country, must be considered separately. Credits may not be claimed for income taxes paid on any other class to reduce taxes otherwise payable on a different class. Foreign tax credits are restricted to tax paid only on foreign source income.

The following are the classes of income considered for the purposes of filing form 1116:

- Passive income.
- High withholding tax interest.
- Financial services income.
- Shipping income.
- Certain dividends from a domestic international sales corporation (DISC) or former DISC.
- Certain distributions from a foreign sales corporation (FSC) or former FSC.
- Any lump-sum distributions from employer benefit plans for which the 5 or 10–year tax option is used to determine your tax.
- Section 901(j) income.
- Income re-sourced by treaty.
- All other income not included above (general limitation income).

The purpose of the different income classes is to prevent the payment of tax on a highly taxed income class from offsetting other income earned in lower taxed classes. (Effective for 2007 returns, the number of classes is limited to two – general limitation and passive.)

U.S. citizens living and working in Canada may find that they have paid Canadian income taxes on employment or other income. 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 which cannot be used in a given year can be carried forward to be used in respect of the same category of income in future periods for a limited time.

(c) Foreign Earned Income and Housing Exclusion

If you are a U.S. citizen or resident alien and if you meet the following tests, you can elect the "foreign earned income exclusion" provided for in Section 911 of the Internal Revenue Code. If you qualify, in 2008 you may exclude up to $87,600 of earned income from taxation in the U.S.

Beginning in 2008, the exclusion amount will be indexed for inflation.

First, you must have a "tax home" in a foreign country. This means your main place of business or employment must be in a foreign country on either a permanent or indefinite basis. Your principal home can still be in the U.S., but if your foreign assignment is merely temporary, you will not qualify for the exclusion. Even if your foreign assignment is temporary and you do not qualify for the exclusion, lodging and meals expenses of a temporary assignment can be deductible travel expenses. Your assignment will not be considered temporary, however, if it's for more than a year. Secondly, while having the above tax home, you must either meet the bona fide foreign residence test or the foreign physical presence test.

(i) Bona Fide Residence Test

To meet the bona fide foreign residence test, you must be a bona fide resident of one or more foreign countries for an uninterrupted period fully covering at least one calendar tax year (i.e., Jan. through Dec.). Broadly speaking, you're a bona fide resident if you have the intent to live there for the time being. You can still intend to return to live in the U.S. eventually. Also, temporary brief trips back for vacation or business will not cause you to fail this test. If you make a statement to the taxation authorities in the foreign country that you are not a resident for tax purposes, you will fail the Bona Fide Residence test.

(ii) Physical Presence Test

For the physical presence test, you must be physically present in a foreign country for 330 full days during a period of 12 consecutive months. For this test, the

months do not have to cover an entire calendar tax year but they can run, for example, from June through May of the next year. Interestingly enough, the same periods may be used to qualify for successive years, or the days may overlap from one year to the next. In this way you can use some of the same days as in the prior year to qualify for the current year.

If you qualify under the above tests, you can exclude the lesser of (1) $87,600 or (2) your foreign earned income for the year. (If your spouse qualifies as well, an exclusion is separately determined for him or her.) Remember that the exclusion applies to earned income only, and for example income paid by the U.S. government and income received as a pension or annuity is not included in foreign earned income. The $80,000 amount must be computed on a daily basis if you do not satisfy the tests for the entire year. If, for example, you qualify for the exclusion under the bona fide residence test for the last 40 days of 2008 (and then for all of 2009). For 2008, the maximum exclusion is 40/365 times $87,600, which equals $9,600. (For 2006, the entire $87,600 -indexed for inflation- exclusion is available.) A similar adjustment would be made if your qualifying days under the physical presence test were less than 365 for the year.

(d) Foreign Housing Exclusion

If your employer covers all or part of your foreign housing costs you may also qualify for a foreign housing cost exclusion. (In some cases, however, this may reduce your foreign earned income exclusion.)

(e) Claiming Foreign Tax Credits vs the Earned Income Exclusion

Note that the foreign earned income exclusion is elective, not automatic. If you elect to take advantage of the exclusion, you cannot also claim a tax credit for taxes paid to a foreign country allocable to the excluded income. Thus, in some cases you will have to compare the tax savings of the exclusion with those of a credit. Since the foreign earned income exclusion is deducted from the "bottom" rate of tax, more intensive comparison may be necessary.

Here are some income tax planning considerations when determining which to claim:

- If you are an employee who expects to work in countries that have a lower tax rate than the U.S., the election should be made.
- If you are engaged in a profitable trade or business in a foreign country that has a lower tax rate than the U.S., the foreign earned income exclusion should be made.
- If your tax liability can be offset completely by a foreign tax credit, the election shouldn't be made. Due to the offset, there is no advantage to making the election, but by making it, you may restrict future flexibility.
- If you are engaged in a trade or business in a foreign country that produces a net loss, claiming the foreign earned income exclusion will result in a reduction of expenses attributed to the excluded income. This may reduce the loss available to offset other worldwide income to your disadvantage.

(f) Alternative Minimum Tax

The operation of the Alternative Minimum Tax (AMT) rules may sometimes limit the benefit of items otherwise deductible. Based upon the principle that "preference items" should not completely eliminate taxes, all income items and deductions are re-calculated using the 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. Care should be taken to take the AMT consequences into account in any international tax plan.

Starting for 2005 returns, the former rule which allowed only 90% of AMT to be reduced by foreign tax credits has been eliminated, allowing a full claim for foreign tax credits against AMT, thus eliminating AMT for many expatriates.

(g) 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 U.S. citizen working in Canada on a temporary assignment (of up to 5 years) for a U.S. company is exempt from

Canada Pension Plan (CPP) if he remains covered by U.S. social security.

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

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

Even though all Canadian social security taxes are available as a foreign tax credit to U.S. citizens working Canada (subject to limitation for income excluded under IRC 911) – resulting in no overall increase in tax to the employee, the benefits of the Totalization agreement are:

- If the employee were engaged in Canada for less than the 10 year minimum period for eligibility for CPP pension, all CPP contributions would be wasted.
- While the employee is working temporarily in Canada, social security taxes will continue to be paid, and will count toward eventual Social Security benefits;

(h) Canadian RRSP's and U.S. Taxes

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, since an RRSP is treated in the U.S. as a foreign grantor trust. An election on form 8891 must be made in each year, together with the U.S. tax return filed, to prevent current taxation of undistributed RRSP income from RRSP principal which was contributed while the taxpayer was a resident of Canada.

1.05 U.S. Corporate Rules Applicable to U.S. Citizens

(a) Controlled Foreign Corporations – Form 5471

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 (subject to some deductions for qualifying deficits).

Subpart F income includes income of the foreign corporation which relates to passive activities like rents, interest and dividends (unless part of active business) illegal payments, bribes, etc., services rendered outside the foreign country, foreign personal holding company income, sales commissions earned for sales outside of the foreign country, etc. as defined below. Subpart F income does not include active business income from operation of a business in the foreign country.

The thrust is to include in US personal taxable income passive income of US persons which has been channeled through a foreign country.

In order to disclose all relevant information related to a Canadian Corporation, form 5471 must be filed each year with the individuals form 1040 individual income tax return, and also separately with Internal Revenue Service in Philadelphia. Form 5471 requires a comprehensive reporting of all transactions which have occurred within the foreign corporation during its last fiscal year.

This means that a detailed report about balance sheet items, income statement items, and transactions with shareholders must be reported on a multi-page form, both in United States dollars and foreign currency. There are serious penalties for failure to file form 5471.

(b) Accumulated Earnings Tax

Under U.S. corporate law, companies which exceed certain threshold amounts of retained earnings are required to pay a penalty tax on accumulated earnings. This law is contrary to the usual method of Canadian corporate tax planning, where earnings tax paid at the low small business deduction rate of 23% in Canada are left in small companies to accumulate indefinitely.

Since U.S. citizens living in Canada are required to apply U.S. law to corporations which they control, this favored method of tax planning in Canada is not available, and dividends must be paid out regularly to

ensure that the Canadian corporation does not exceed U.S. accumulated earnings tax thresholds. Failure to do so will result in double taxation, and taxation at very high rates.

(c) Other U.S. Corporate Rules

U.S. citizens who control or have a significant interest in Canadian or other foreign businesses, corporation, or trust must consider the U.S. tax consequences of any action taken within the foreign corporation or trust, to prevent unexpected taxation in the U.S.

1.06 Ceasing to be Taxable in The U.S. or Canada

In order to cease to be taxable in Canada, an individual must give up Canadian residence, and in the case of non-U.S. citizens, U.S. residence. A U.S. citizen may cease to be taxable in the U.S. only under certain circumstances, and only by revoking U.S. citizenship before a consular officer.

(a) Revoking U.S. Citizenship or Long Term U.S. Residence

(i) Mark to Market Tax:

Effective June 17, 2008, new Internal Revenue Code section 877A provides for an expatriation tax for “covered expatriates”. Effectively, this means that the expatriate is deemed to have disposed of all capital property at fair market value as of the date of expatriation, and must pay tax on the net gain if it exceeds $600,000 (indexed for inflation. This is called the “mark to market” tax.

In order to be subject to the “mark to market” tax, an individual must first be considered an “expatriate” and then must meet one of several tests to become a “covered expatriate”.

(ii) U.S. Citizen Expatriates:

A U.S. citizen becomes an “expatriate” on the earliest of the following dates:
- The date U.S. nationality is renounced before a U.S. consular officer;
- The date the individual provides a written statement of voluntary relinquishment of U.S. nationality which is accepted by the State Department;
- The date the State Department issues a certificate of loss of nationality; or
- The date a U.S. court cancels a certificate of naturalization.

(iii) Long Term Resident Expatriates

An individual is considered a “long term resident” of the U.S. is a person who was a lawful permanent resident of the U.S. for at least eight of the past 15 tax years. Long term residential status is terminated by losing a green card status, either through revocation or by abandoning residential status. An individual also ceases to be treated as a long term permanent resident of the U.S. if they are treated as a resident of another country with which the U.S. has a Treaty, and if they do not waive rights under that Treaty, and notifies the Secretary of State of that treatment.

Caution is therefore required by any long term green card holder who does not meet the residential requirements of that status, since they may inadvertently become expatriates under IRS code 877A.

A U.S. citizen who lives abroad and who does not revoke the application of any foreign tax treaty, is deemed for U.S. purposes to be taxable in the U.S. Accordingly, the 10 year period begins only after the revocation of citizenship and the cessation of the use of treaty provisions.

(iv) Covered Expatriates:

In order to be subject to the “mark to market” tax , an expatriate must be considered a “covered expatriate” by meeting one of the following tests:

1) Average net income tax liability in the U.S. for the past five years must exceed $124,000 per year;
2) The individual must have a net worth exceeding $2 million dollars; or
3) The individual has not complied with U.S. tax filing obligations for the prior five years.

Note the importance for all persons who hold U.S. citizenship or residential status to file U.S. income tax returns each year.

The above tests do not apply to minors, or persons who were born both as a U.S. citizen, and the citizen of another country.

(v) Calculation of the Tax:

Any individual who expatriates on or after June 17, 2008 must complete and file form 8854 to satisfy

whether they meet the "expatriate" and "covered expatriate" tests, and to provide net worth, income, and basis information required to calculate the tax, if it is applicable.

The tax is calculated under normal IRS code provisions as if all property was disposed of at fair market value as of the expatriation date, but only if the net gain exceeds $600,000. Wash sale rules, deferral benefits such as incomplete like-kind exchanges, and involuntary conversions are eliminated. The stepped up basis rule applies to property that was held on the date an individual first became a U.S. resident as defined in IRC 7701(b), unless an irrevocable election is made not to have this rule apply.

(b) Leaving Canada - Canadian Taxation of Non Residents

Persons who are not residents of Canada are taxable in Canada on income from Canadian sources. Although this is a very large topic in taxation, this article will limit discussion to the taxation of former residents of Canada who derive income from Canada.

(i) Consequences of Leaving Canada

(See also 1.03 for a discussion of deemed residents and deemed non residents of Canada)
Where an individual ceases to be a resident of Canada there is deemed to be a disposition of all of the property of the individual at fair market value, and an immediate deemed re-acquisition of the property. The effect of this is to ensure that a person departing Canada will be subject to capital gains tax on accrued increases in property value while a resident of Canada. "Taxable Canadian Property", including real estate, stocks & bonds, and some other assets are exempt from this treatment, but the taxpayer may elect pursuant to Para. 128.1(4) of the Income Tax Act (Canada) to dispose of any or all of these items in any event.

No provision is made in the U.S. for revaluing the capital property at the time of entry into the U.S. Unlike the Canadian capital gains rules, which intend to tax capital gains only while a resident of Canada, dispositions of property by U.S. citizens will be subject to U.S. tax on the entire gain or loss from the date of acquisition.

(ii) Rental Real Estate in Canada

Where a non resident receives rental income from sources in Canada, the non resident may elect pursuant to Para. 216 of the Act to file a return of his income respecting the rental property under Part I, rather than being taxed under Part XIII (withholding taxes - non residents). 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. Of course, all rental income must be disclosed on schedule E to form 1040 in the U.S., subject to foreign tax credits for taxes paid abroad.

(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, and would trigger taxation in both countries under the Convention. Accordingly, persons returning to the U.S. after a work period in Canada should consider leaving their RRSP intact, and drawing funds from the plan only upon retirement or as provided for under Canadian law.

Upon withdrawal, Canadian RRSP funds will be subject to a 25% non resident withholding tax (to non residents) and a non resident may elect to file a return under Para 217 of the Income Tax Act respecting RRSP income in any year. Para 217 permits the filing of a return to include only the RRSP income of the non resident, but uses the non resident's world income for calculation purposes. This elective return is normally beneficial to persons not earning any income while a non resident

For U.S. tax purposes, RRSP withdrawals are taxable only to the extent that income (and not contributed principal) was withdrawn from the plan, since no deduction was available in the U.S. when the contributions were made to the RRSP. Further, income earned within the plan while not a U.S. resident or citizen will also not be taxable for U.S. purposes.

(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.

1.07 U.S. Vs Canadian Estate Taxation

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

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(a) 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 2006. 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 exemption against estate tax is reduced by taxable lifetime gifts exceeding the annual gift limit, thus reducing the opportunity for distributing an estate during the lifetime of the decedent.

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.

(b) Receipt of Gifts From Abroad

If the value of aggregate foreign gifts that you receive during any year exceeds $13,000, for 2009. A foreign gift is any amount you receive from a non-US person which you treat as a gift or bequest. A non-US person is any person other than a citizen or resident of the US or a domestic partnership or corporation. The term non-US person also includes a foreign estate or a trust treated as a foreign trust.

Foreign gifts do not include qualified tuition or medical payments made on behalf of the recipient or gifts which are otherwise properly disclosed on a return under the separate requirements applicable to amounts received from foreign trusts. Foreign gifts and bequests which are reportable, must be reported each year on the new form 3520.

(c) 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, with the tax payable by the estate. Tax deferred items, such as RRSP's are deemed to be disposed of at the same time, giving rise to regular income for the estate in the year of death, subject to certain rollovers available to the spouse of the deceased. In order to alleviate some of the tax burden resulting from these dispositions, the estate 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. A personal exemption may be claimed on each of the returns, and income tax is calculated on each return at graduated rates, starting from zero. 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.

(d) U.S. Estate Taxation of Non resident Aliens

The Death Tax Elimination Act signed on March 29, 2001 taxes only assets located in the U.S. and allows an exemption of the greater of $60,000 or the

proportion of $175,000 that the U.S. situated assets represent of the entire estate. In international estates, the marital credit is limited to spouses who are U.S. citizens.

(e) 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. Small estates (currently not in excess of 1.2 million dollars in worldwide assets) are exempt from estate taxation in the U.S., but may be subject to taxation in Canada if any unrealized capital gains exist.

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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