Taxation of Americans in Canada

Dale Walters, CPA, PFS, CFP®
with Sally Taylor, CPA, and David Levine, CA, CPA

Self-Counsel Press
(a division of)
International Self-Counsel Press Ltd.
USA Canada

Self-Counsel Press acknowledges the financial support of the Government of Canada through the Canada Book Fund (CBF) for our publishing activities.

Printed in Canada.

First edition: 2016

Library and Archives Canada Cataloguing in Publication

Walters, Dale, 1958-, author
Taxation of Americans in Canada : are you at risk? / Dale Walters, CPA, PFS, CFP® ; with Sally Taylor, CPA, and David Levine, CA, CPA.

Issued in print and electronic formats.

ISBN 978-1-77040-147-1 (paperback).—ISBN 978-1-77040-874-6 (epub).—ISBN 978-1-77040-875-3 (kindle)

1. Americans—Canada—Finance, Personal. 2. Americans—Taxation—Law and legislation—Canada. 3. Americans—Legal status, laws, etc.—Canada. 4. Income tax—Law and legislation—United States. I. Taylor, Sally, author II. Levine, David, author III. Title.

HG179.W33 2016 332.024'008913071 C2016-901703-6
C2016-901704-4

Self-Counsel Press
(a division of)
International Self-Counsel Press Ltd.

Bellingham, WA
USA

North Vancouver, BC
Canada

Contents

Tables

Notice to Readers

Laws are constantly changing. Every effort is made to keep this publication as current as possible. However, the author, the publisher, and the vendor of this book make no representations or warranties regarding the outcome or the use to which the information in this book is put and are not assuming any liability for any claims, losses, or damages arising out of the use of this book. The reader should not rely on the author or the publisher of this book for any professional advice. Please be sure that you have the most recent edition.

Prices, commissions, fees, and other costs mentioned in the text or shown in examples in this book may not reflect real costs where you live. Inflation and other factors, including geography, can cause the costs you might encounter to be much higher or even much lower than those we show. The dollar amounts shown are simply intended as representative examples.

Circular 230 Disclaimer: Nothing in this book is to be used or relied upon by anyone for the purposes of avoiding penalties that may be imposed on you under the Internal Revenue Code of 1986, as amended. Any statements contained within this book relating to any federal tax transaction or matter may not be used by any person to support the promotion or marketing to recommend any federal tax transaction. Everyone should seek advice based on individual circumstances from a qualified independent cross-border tax advisor. No one, without express written permission, may use any part of this book in promoting, marketing, or recommending an arrangement relating to any federal tax matter to anyone else.

Acknowledgments

Robert (Bob) Keats, saw a need for US-Canada financial planning, and has been serving Canadians and Americans with cross-border issues for more than 30 years. In 1990, he founded Keats, Connelly and Associates, which is now called KeatsConnelly. It is because of Bob's foresight and hard work that we are now able to write a book dedicated solely to the taxation of Americans in Canada.

We also want to acknowledge all of the KeatsConnelly employees, past and present, on their contributions to this book. This is the cumulative effort of decades of employees learning this subject matter by working directly with clients day after day, year after year. We have tried to capture their cumulative knowledge in this book.

Ultimately, if it were not for the support and understanding of our spouses we would not have been able to accomplish such a large undertaking as this. Because the time we spent researching, writing, and editing took away time from our families, their patience and encouragement to finish the book was essential.

This is the second book that the authors have collaborated on and the fifth in the Cross-Border Series. The success of these books is due entirely to people like you who buy and read our books. We have been told that some of you have read every book in the series. To you and all of the readers of these books, we sincerely say: Thank you!

Lastly, we want to thank all of the clients we have worked with over the years. It is our clients who have put us in a position to be able to write a book on this topic in the first place. Without them this book would not have been possible. It is for them and all future clients that we write this book.

1

Before You Go to Canada

Assuming you decide Canada is the right place for you and you're not already resident, before you move to Canada, you need do a lot of planning. Just moving across town you have to think about what to take and what to leave behind. You have to think about how to notify everyone of your new phone number and mailing address. You have to decide about packing and physically moving your belongings, and whether to do it yourself or hire a moving company.

When moving to a new country, the issues are exponentially more complex. You may think about immigration, applying for health insurance, and obtaining a tax ID number. Unfortunately, tax planning is typically ignored or postponed until it is too late.

1. Planning Your Move

Canada provides a number of good resources that will help with your move, but before you look at those resources you must consider the implications of leaving the US.

From a tax perspective, there are three broad categories that people fall into when leaving the US and each has different tax ramifications. The categories are US citizens, long-term permanent residents (green card holders), and anyone that is neither a US citizen nor a long-term green card holder. A long-term permanent resident is defined as a person who has been a "Lawful

Permanent Resident," also known as a green card holder, for at least 8 out of the last 15 years.

Note: The definition of a long-term resident is very precise and applies only to green card holders. Therefore you can be in the US for 10, 20, or more years using a Visa and you would never be considered a long-term permanent resident.

The easiest category from a tax perspective is that of US citizens that continue to retain their US citizenship when they move out of the US. As a US citizen, you simply need to do some tax planning before you move. We will talk about tax planning and expatriation later in this chapter.

If you are not a US citizen and are not a long-term green card holder, you are required to obtain a Certificate of Compliance, also known as a Sailing Permit, before leaving the US. To get a Certificate of Compliance, you must go to a local IRS office between two and four weeks before leaving the US. You must file either the Form 2063 tax statement (short form) or the Form 1040-C tax return (long form) and take it with you to an IRS office to obtain a Certificate of Compliance. The certificate cannot be issued more than 30 days before you leave. If you are married, you each must receive a clearance certificate; therefore you and your spouse must each file one of the forms and go to the IRS office.

Form 2063 is the short form that asks for some basic information, but does not compute the tax due. You are qualified to use the short form if you have filed a least one tax return (and paid tax, if applicable) in the US, and are an —

- individual who had no taxable income during the year up to the date of departure, or
- individual who had taxable income during the year or preceding year and "whose departure will not hinder the collection of any tax." If the IRS has information indicating that you are leaving to avoid paying tax, you must file Form 1040-C and pay the tax.

Examples of aliens not required to obtain a Certificate of Compliance are diplomats; students; those receiving no taxable income; and alien residents of Canada or Mexico who commute and have wages that are subject to withholding.

Important: We strongly recommend that you call two or more months ahead to schedule an appointment if you are filing one of these forms. It will likely be very difficult to find IRS agents who will know what to do when you call for an appointment since they likely don't encounter these forms on a daily basis. Calling ahead will give you and them time to find someone who knows what to do, or at least the opportunity to learn what to do.

2. Expatriation

US citizens and Lawful Permanent Residents (green card holders) are required to report and pay tax on their worldwide income, regardless of where they reside. To remove yourself from the US tax system, you must give up your citizenship or green card and become a nonresident alien. For US citizens to become nonresident aliens, they must renounce their citizenship and move to another country.

An expatriation tax applies to US citizens who renounce their citizenship and long-term residents who end their residency. A long-term resident is defined as someone who has been a green card holder for at least 8 of the 15 years prior to expatriation.

For those of you eligible to become US citizens who are deciding whether to become citizens before you leave, we would say that there are a lot of factors that must be considered and weighed before making that decision. Things to consider are:

- There is no income tax difference between a citizen and a long-term green card holder, before, during, or after expatriation.
- The advantages of citizenship over being a green card holder are:
  - Estate tax advantage: US citizens are allowed to receive unlimited assets from a spouse they are legally married to, without the deceased spouse paying US estate tax at his or her death.
  - The right to vote in US elections.
  - Protection or assistance by the US government and/or military when overseas.
  - The right to enter the US and stay as long as you desire.

The benefits green card holders have are —

- green cards are easier to give up than citizenship, if that time ever comes, and
- it is possible to relinquish and reacquire green card status, where it is nearly impossible to reacquire citizenship if it is surrendered.

2.1 Relinquishing US citizenship

You are considered to have relinquished your US citizenship on the earliest of the following dates:

1. The date you renounce your US citizenship before a diplomatic or consular officer of the US, assuming the renouncement was later confirmed by the issuance of a Certificate of Loss of Nationality (CLN).

2. The date the State Department issues a CLN.
3. The date a US court cancels your Certificate of Naturalization.

2.2 Relinquishing Lawful Permanent Resident status

A long-term resident terminates his or her residency on the earliest of the following dates:

1. The date he or she voluntarily abandons Lawful Permanent Resident status by filing Form I-407 with a US consular or immigration officer and they have determined that he or she has, in fact, abandoned Lawful Permanent Resident status.
2. The date he or she becomes subject to a final administrative order for removal from the US under the Immigration and Nationality Act, and actually leaves the US as a result of that order.
3. If he or she was a dual resident of the US and a country with which the US has an income tax treaty (such as Canada), the date he or she commences to be treated as a resident of that country and determines that, for purposes of the treaty, he or she is a resident of the treaty country and gives notice to the Secretary of such treatment.

Although a person who expatriates will be treated as a nonresident alien, he or she may be classified as a "covered expatriate," which would subject the person to an exit tax, similar to the tax Canada imposes on its residents when they leave Canada and become residents of other countries. The exit tax imposes an immediate tax, as well as potential future taxes on the expatriate. A covered expatriate is either a US citizen or long-term resident who abandons or loses his or her status as a US citizen or permanent resident, and as of the day before expatriation has:

1. Average net income tax for the last five years of more than $161,000 (2016), or
2. Net worth on the date of expatriation of $2 million or more, or
3. Failed to certify, under penalty of perjury, that he or she has complied with all US federal tax obligations for the five years preceding the date of expatriation or termination of residency. Certification is done using Form 8854 (more on this form later). This form is completed when filing Form 1040 (or 1040NR) for the year of expatriation.

The income tax amount of $161,000 is increased for cost-of-living adjustment each year. There is no adjustment for the net worth amount of $2 million. The $161,000 amount is the tax, not the income. This means that if you assume an average or effective tax rate of 30%, you need over $525,000 of taxable income (not gross income). This seems like a much higher threshold than $2 million net worth, so the vast majority of those expatriating will be considered a covered expatriate due to having a net worth in excess of $2 million.

If you expatriate and you are considered a covered expatriate, you will be subject to a "mark-to-market tax," also known as a deemed disposition of your worldwide assets, and will be required to recognize gain on those assets as if they were sold at their fair market value as of the day prior to your expatriation.

Note: If you are a long-term resident, you have the option to use the fair market value of your assets on the day your US residency began. For the assets you owned when you moved to the US, this will, in most cases, be a higher number and therefore produce a lower gain than using the original purchase price.

There are three groups of assets that are not subject to the mark-to-market tax, but will be taxed using a different method: 1) deferred compensation, 2) tax-deferred accounts, and 3) an interest in a non-grantor trust. If you have one or more of these types of accounts, you must file Form W-8CE within 30 days of expatriation.

Deferred compensation is divided into two types; one that has a US payor that is required to withhold on all payments, and one for all other deferred compensation arrangements. Where US withholding is required, payment can be deferred until payment is made, but the withholding must be 30%. The covered expatriate cannot claim, under the treaty, to reduce the withholding. For all other deferred compensation arrangements, the accrued benefit will be treated as being received the day before expatriation.

Examples of deferred compensation plans include a company pension or profit sharing plan (including 401(k) and 403(b) accounts), simplified employee pensions (SEP), and simplified retirement accounts (SIMPLE plans).

Any interests in a foreign pension or retirement account are considered deferred compensation plans and are included in the expatriation tax. This includes your RRSPs, RRIFs, LIRAs, any Canadian company pension, and government or military pension, but does not include Canadian Pension Plan or Old Age Security, which are forms of social security.

Tax-deferred accounts are individual retirement plans, a qualified tuition plan (aka Section 529 Plan), a Coverdell Education Savings Account, a health savings account, and an Archer MSA. However, Simplified Employee Pension (SEP) and SIMPLE IRA plans of a covered expatriate are treated as deferred compensation items described above. These plans are treated as if the entire interest was paid out on the day prior to expatriation.

The definition of a non-grantor trust is a trust that occurs when the grantor gives the control of the trust property to a trustee other than himself. In other words, a non-grantor trust is a trust that someone established for the benefit of someone other than himself or herself. So, if someone (your parent for example) established a trust in which you are the beneficiary, or at least one of the beneficiaries, the value of your share of the trust is subject to the expatriation tax. If you are the beneficiary of such a trust, the trustee must withhold 30% of any direct or indirect distributions. This withholding rule applies to both domestic (US) and foreign (non-US) trusts.

There are two exceptions from the automatic treatment of the tax described above. The first is for a dual citizen who became a US citizen at birth and must have also become a citizen of the other country at birth, or someone who was a resident of the US for 10 years or less, out of the last 15, prior to the year in which the expatriation occurred. This second exception refers to naturalized citizens (those who went through the process of becoming a US citizen).

The second exception is for certain minors, if (and only if) all of the following conditions are met —

- the minor became a US citizen at birth,
- expatriation occurs before attaining age 18, and
- the minor was not a US resident for more than ten years before expatriation occurs.

Important: If you are subject to the expatriate tax regime, the US provides an exemption from the tax on gains in excess of $693,000 (2016 and indexed for inflation). This means that many of you will not owe tax upon expatriating. If your gain is greater than $693,000, you pay tax on the difference.

Note: you can make an irrevocable election to defer the payment of the tax. If you make the election, the following rules apply:

1. You must make the election on a property-by-property basis.
2. The deferred tax on a particular property is due on the return for the tax year in which you dispose of the property.
3. You must provide adequate security, such as a bond.
4. Interest is charged for the period the tax is deferred.
5. The due date for the payment of the deferred tax cannot be extended beyond the earlier of the following dates:
   - The due date of the return required for the year of death.
   - The time that the security provided for the property fails to be adequate.
6. You must make an irrevocable waiver of any right under any treaty of the US that would preclude assessment or collection of any tax imposed under this expatriation regime.

7. You must file Form 8854 annually for each year, up to and including the year in which the full amount of deferred tax and interest is paid.

Important: The consequence of being in the US for more than 30 days, in any calendar year, after expatriation is that you will be treated as a US citizen for tax purposes and taxed on your worldwide income. This rule will apply for the longer of ten years or until the full amount of deferred tax and interest is paid. There is one exception to this rule. You can be in the US for up to 60 days without being treated as a US citizen if any of the following requirements are met:

- you were performing personal services in the US for an employer who is not related to you, and you meet these additional requirements;
- you were a US citizen and, within a reasonable period of time following your expatriation, you became a citizen or resident, fully liable to tax in the country in which you, your spouse, or either of your parents were born; or
- for each year, in the ten years prior to your expatriation, you were physically present in the US for 30 days or fewer.

Form 8854: Initial and Annual Expatriation Statement must be filed upon the date of renunciation with the American Citizen Services section of the nearest American Embassy or consulate. (See the Resources at the back of this book for a list of forms and where to find them as you read through this book.)

In addition to the information discussed in the preceding sections, the following information is required:

1. the taxpayer's identification number (Social Security number),
2. the mailing address of the principal foreign residence,
3. expatriation date,
4. the foreign country in which the individual is residing,
5. the foreign country or countries of which the individual is a citizen and the date he or she became a citizen of those foreign countries,
6. information detailing the income, assets, and liabilities of the individual,
7. the number of days during any portion of which the individual was physically present in the US during the taxable year, and
8. how he or she became a US citizen (birth or naturalization).

3. Your Rights after US Citizenship Is Terminated

After your renunciation, you will have the same rights in the US as any other citizen of Canada or whatever country of which you are a citizen.

Note: If you renounce your citizenship:

- You lose the right to live and work in the US.
- You will not be able to vote in US elections.
- You will not be entitled to the protection of the United States when in other parts of the world.
- You will no longer be able to enter and remain indefinitely in the US.
- Any children you have who are born after your renunciation will not receive US citizenship from you (although they may receive US citizenship from the other parent, from birth on US soil, from naturalization later in life, etc.).

Important: There are no temporary renunciations or options to reacquire US citizenship. Renunciation of US citizenship is irrevocable; you lose citizenship for the rest of your life.

After your renunciation, your biometric information — fingerprints and digital photograph — will be taken and stored by the US either when you apply for a visa or when you enter the US. This policy applies to all non-US citizens from the ages of 14 to 79.

3.1 The Reed Amendment

The only law that calls for different treatment of expatriates is the Reed Amendment. In 1996, Congress included a provision in the expatriation law to bar entry to any individual "who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the United States."

This amendment added ex-citizens to the list of other "inadmissibles," which includes practicing polygamists, international child abductors, and aliens who have unlawfully voted in US elections.

Note: As of this writing, the Reed Amendment has never been imposed. So, while in theory it is possible that the US could bar you from entry because the Attorney General believes you expatriated with the primary purpose of avoiding US taxation, we think the chances are extremely low that this would ever happen under current law.

4. Tax Planning before You Go

Most of you will not be subject to the expatriation tax, but you should still do some tax planning before giving up your citizenship or green card. The best tax planning opportunities exist only while you are still a US taxpayer and before you become a taxpayer of Canada.

Because a complete discussion of this topic is outside the scope of this book, we will highlight the main issues to consider before leaving the US:

- Should I renounce my US citizenship? What are the pros and cons?
- Should I surrender my green card? What are the pros and cons?
- How should I address the foreign currency issues I will face?
- What should I do with my bank and nonqualified (non-registered) brokerage accounts in the US?
- What should I do with my qualified (registered) accounts (e.g., IRA and 401[k]) in the US?
- I still have registered accounts (e.g., RRSPs) in Canada, should I cash them out before returning to Canada?
- What should I do with my home in the US? If I do not sell it before leaving, what are the tax consequences?
- I have entities such as US corporations or partnerships, what should I do with them?
- If applicable, what should I do about US Social Security and/or Medicare?
- What should I do about health insurance?
- What is the fair market value of all of your capital assets on the date of exit, even if you do not have to file Form 8854, because you will typically want to use these values as your cost basis when you sell those assets in Canada? This could be as easy as statements from your brokerage firm or you may have to go as far as getting appraisals on some of the assets.

4.1 US bank and nonqualified brokerage accounts

When moving to Canada, you will need to decide which accounts you will leave in the US, if any, and what accounts you will close and move to Canada. For bank accounts (checking, savings, certificates of deposit), we recommend that you take most, or all, of the assets to Canada. The problems to be addressed are currency risk and complexity. If you leave your bank accounts in the US you will subject that money to currency exchange risk. However, if you plan on spending time in the US and therefore spending US dollars, you might want to keep some money in the US to spend while visiting.

The second issue to consider is the additional complexity of having a US account. A US account may lead to additional Canadian tax reporting. If you have more than $100,000 CAD in foreign (non-Canadian) assets, you must report them on Form T1135, Foreign Income Verification Statement. If you continue to own a home in the US, you will be over the threshold and you would be required to report the home, the bank accounts, and any other foreign assets.

Note: Canadian banks allow you to have US- and Canadian-dollar dominated accounts, so in most cases there is no real advantage to keeping your bank accounts in the US.

4.2 Nonqualified US brokerage accounts

Determining what to do with your nonqualified brokerage accounts is more complicated than the question of what to do with your bank accounts. Nonqualified brokerage accounts are investment accounts that are not qualified retirement accounts such as a 401(k) or IRA.

The biggest problem is that most financial advisors are not allowed to trade your account once you become a nonresident of the US. This has to do with securities laws and who has jurisdiction/oversight of the advisor trading your account. Only a very small number of advisory firms such as KeatsConnelly are registered in the US and Canada, and can manage your accounts in both countries in a coordinated fashion. Companies such as RBC, TD, and BMO are registered in both countries, but the individual advisors are not, which causes a disconnection in the managing of the accounts.

Canada is an expensive place to invest. In 2012, the Canadian Securities Administrators published a discussion paper[1] and request for comment on Canadian mutual fund fees, which found that Canadian mutual funds are the most expensive in the world. Other problems include:

- Fewer investment choices.
- The Canadian economy is not as diverse as the US's, therefore portfolios are less diverse, which tends to lead to more volatility/risk within the portfolio.
- Required reporting standards are not up to par. While the US has required that investors receive at least quarterly reports and performance results on investment accounts for decades, Canada required reporting for the first time as of July 2016.
- Most advisors in Canada are commissioned salespeople.

1 Ontario Securities Commission, "CANADIAN SECURITIES ADMINISTRATORS DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407 MUTUAL FUND FEES," accessed January, 2016. www.osc.gov.on.ca/documents/en/Securities-Category8/csa_2012123_81-407_rfc-mutual-fund-fees.pdf

In summary, if you are a do-it-yourself kind of investor, you will not be able to leave your nonregistered accounts in the US. If you are willing to pay for professional advice you will be limited to a handful of choices, otherwise you will need to close your US accounts and move them to Canada.

4.3 Qualified accounts

With qualified accounts, you will have to leave the accounts in the US or pay the tax to cash them out and move them to Canada. If you cash out your accounts before age 59, you will also be subject to a 10% penalty.

For your qualified accounts, you are forced to find an advisor who will continue to hold your accounts once you become a Canadian resident, or cash your accounts out and pay the tax. In Chapter 6 we go into detail about the possibility of rolling over your IRA to and RRSP. Though it is possible to roll over your IRA to an RRSP, it is typically not a good idea.

4.4 Cashing out your IRA, 401(k), or RRSP

Speaking of possibly cashing out your IRA or 401(k), you can add your RRSP to that consideration if you have one. You will want someone to run the numbers on this, but in some circumstances it may be beneficial to pay tax at the lower US rate today rather than defer the tax and pay a higher rate of tax in Canada.

Ignoring the issues of investing in Canada raised above, the basic question is: Does the deferral outweigh the tax savings? Assuming a 5% return and a 35% tax in the US versus a 50% tax in Canada, it will take 16 years for the deferral to outweigh the lower US tax.

Table 1 shows a year-by-year comparison, assuming the deferred account earns 5% until the year of withdrawal, then it is taxed at 50% in Canada. The other calculation is paying 35% up front and the account grows at an after-tax rate of 3.25% (5% less 35% tax). Another option is to convert your traditional IRA to a Roth before moving to Canada. In this case a 40% tax is paid up front, but no further tax is owing so the Roth grows at 5%. Starting amount is $1,000.

A similar calculation would have to be made when deciding whether it makes sense to convert your traditional IRA to a Roth before moving to Canada. If you convert to a Roth, you will not have to pay the 50% Canadian tax so you would be comparing a higher US tax today, versus allowing the Roth to grow tax-free. You will need to run the calculations based on your actual tax situation, but based on the assumptions above, the Roth conversion is the best choice.

As we explained, we recommend going to a cross-border specialist to get these and other questions answered before you leave the US.

See the Resources at the end of the book for further readings on moving to Canada.

Table 1
COMPARISON WHEN CASHING OUT ACCOUNTS

End of Year	Defer IRA	Defer IRA AfterTax @ 50%	Tax IRA Now @ 35%	Convert to Roth @40%
0	$1,000.00	N/A	$650.00	$600.00
1	$1,050.00	$525.00	$671.13	$630.00
2	$1,102.50	$551.25	$692.94	$661.50
3	$1,157.63	$578.81	$715.46	$694.58
4	$1,215.51	$607.75	$738.71	$729.30
5	$1,276.28	$638.14	$762.72	$765.77
6	$1,340.10	$670.05	$787.51	$804.06
7	$1,407.10	$703.55	$813.10	$844.26
8	$1,477.46	$738.73	$839.53	$886.47
9	$1,551.33	$775.66	$866.81	$930.80
10	$1,628.89	$814.45	$894.98	$977.34
11	$1,710.34	$855.17	$924.07	$1,026.20
12	$1,795.86	$897.93	$954.10	$1,077.51
13	$1,885.65	$942.82	$985.11	$1,131.39
14	$1,979.93	$989.97	$1,017.12	$1,187.96
15	$2,078.93	$1,039.46	$1,050.18	$1,247.36
16	$2,182.87	$1,091.44	$1,084.31	$1,309.72