RBC Wealth Management Services

THE NAVIGATOR

U.S. Residency Status – Canadian Snowbirds Beware

Canadians Traveling to the U.S. Should Understand U.S. Tax Laws

If you are a Canadian resident who spends a considerable amount of time in the U.S., perhaps to escape Canadian winters, you may be surprised to know that your presence in the U.S., even if you are there only vacationing, could create U.S. income tax and other reporting obligations if your U.S. residency status is "U.S. resident alien".

In order to determine your U.S. residency status, the Internal Revenue Service (IRS) applies a test known as the "substantial presence test". This test averages the number of days you were present in the U.S. during the past three-year period, beginning with the current year.

Fortunately, there are circumstances where Canadian residents may be exempt from the status of U.S. resident alien under the substantial presence test and may not have to file a U.S. resident tax return (Form 1040). However, failure to understand the U.S. tax obligations imposed by the IRS may result in unpleasant surprises and costly penalties.

This article will provide Canadians who frequently travel to the U.S. with a basic understanding of U.S. residency under U.S. tax laws, the circumstances where U.S. income tax and reporting obligations may arise and the options available to you. This article is for information purposes only and does not provide tax or legal advice. You should consult with your own tax advisor before acting on any information contained in this article.

This article assumes you are a Canadian resident and not a U.S. citizen or a green card holder.

If you are not a U.S. citizen or green card holder, the substantial presence test is used to determine your U.S. residency status under U.S. domestic tax laws.

Your U.S. Residency Status Determines Your Liability for U.S. Tax

The U.S. imposes income taxes based on U.S. citizenship or U.S. residency status. U.S. citizens and U.S. resident aliens are taxed on their worldwide income while U.S. non-resident aliens are taxed only on income from U.S. sources. A U.S. resident alien is a non-U.S. citizen who is either a U.S. green card holder or meets the substantial presence test, described later in this article.

If a Canadian resident holds a U.S. green card or meets the substantial presence test, they will be considered to be a U.S. resident alien and may be subject to U.S. income tax and other U.S. reporting obligations, similar to a U.S. citizen. This may include having to file a U.S. income tax return as a resident of the U.S. and pay tax on their worldwide income (including Canadian source income) with the entitlement to the same deductions and personal exemptions available to U.S. citizens. In addition, they may have to file other U.S. forms that disclose information regarding financial assets and financial accounts they own that are located outside the U.S.

If a Canadian resident does not hold a U.S. green card and does not meet the substantial presence test, they will be considered to be a U.S. non-resident alien and will only be taxed on income from U.S. sources. The requirement to file a U.S. non-resident tax return will depend on the type of U.S. source income that is earned. For certain types of U.S. source income, such as wages earned in the U.S., a U.S. non-resident tax return is required. For other types of U.S. source income, such as U.S. dividend income, withholding tax at source generally satisfies your U.S. tax obligations so the filing of a U.S. income tax return is typically not required. Note that there are limitations on the deductions and exemptions available on a U.S. non-resident tax return, which otherwise would be available to U. S. citizens or resident aliens filing a U.S. resident tax return.

Determining U.S. Residency Status Under the Substantial Presence Test

If you are not a U.S. citizen or green card holder, the substantial presence test is used to determine your U.S. residency status under U.S. domestic tax laws. The substantial presence test is a two-step test. If you meet the substantial presence test you will be considered to be a U.S. resident alien.

Substantial Presence Test Calculation

Step 1: Were you physically present in the U.S. for at least 31 days in the current year?

If you were not present in the U.S. for at least 31 days in the current year, you can stop here in the test as you will not be considered a U.S. resident alien for this particular year. You will be considered to be a U.S. non-resident alien for U.S. tax purposes.

If you were present in the U.S. in the current year for 183 days or more, there is no need to go to step 2, as you automatically meet the substantial presence test. You will be considered to be a U.S. resident alien for U.S. tax purposes.

If you were present for more than 30 days but less than 183 days, go to step 2 to complete the test to determine your residency status.

Note: When counting the number of days present in the U.S., keep in mind that even if you are present for part of a day, you must count that day as

As a rule of thumb, if you spend more than four months (122 days) every year in the U.S., you will meet the substantial presence test after the third year and annually thereafter, and therefore you will be considered to be a U.S. resident alien.

a full day. For example, a 10-minute trip across the border counts as a full day. There are certain exceptions in the counting. For example, you can exclude days you regularly commute to work in the U.S. from Canada, days you were unable to leave the U.S. due to a medical condition that arose in the U.S. and days you were in transit in the U.S. for less than 24 hours while traveling between two places outside of the U.S. (e.g., you have a layover in Chicago on your way to Uruguay).

Step 2: Does the total number of days you spent in the U.S. over the last three years (using the formula that follows) equal or exceed 183 days?

Formula:
Add all the days you spent in the U.S. in the current year;
plus
1/3 of the days you spent in the U.S. the first year before the current year;
plus
1/6 of the days you spent in the U.S. in the second year before the current year.

If the total number of days using the formula above amounts to 183 days or more, you meet the substantial presence test. You are considered to be a U.S. resident alien for U.S. tax purposes in the current year because you meet step 1 and step 2 of the test (i.e. you were present in the U.S. in the current year for at least 31 days and you were present in the U.S. for 183 days or more over the last three years combined using the formula above).

If the total number of days is less than 183 you do not meet the substantial presence test. You are considered to be a non-resident alien for U.S. tax purposes because you meet step 1 but you don't meet step two of the test.

Substantial Presence Test Calculation Example

If you spent 130 days in the U.S. in each of 2010, 2011, and 2012, your calculation to determine whether you are considered a U.S. resident alien for the 2012 tax year would be as follows:

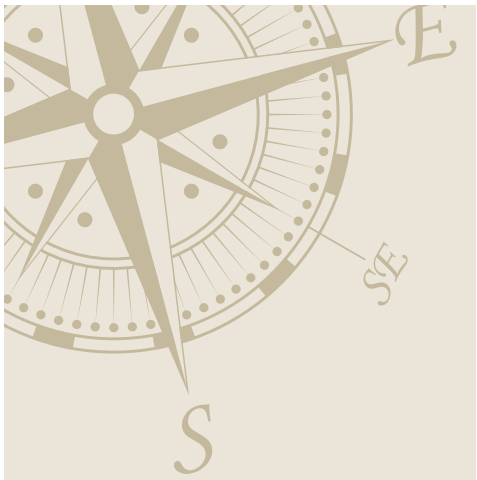
You spent at least 31 days in the U.S. in 2012 (the current year) so you meet the requirements of step 1. For Step 2, the formula results in 195 days of presence in the U.S. over the last three years (i.e., the current year's 130 days plus last year's 130 days divided by 3 plus 2010's 130 days divided by 6; resulting in 130 + 43 + 22 = 195). Since 195 days is over the 182 day guideline, in this example, you meet the substantial presence test in 2012.

As a rule of thumb, if you spend more than four months (122 days) every year in the U.S., you will meet the substantial presence test after the third year and annually thereafter, and therefore you will be considered to be a U.S. resident alien.

The quick reference box summarizes the substantial presence test and may assist you in determining your U.S. residency status.

You ARE a U.S. resident alien – Quick reference box
You are considered a U.S. resident alien (other than a green-card holder) if you spend:
At least 183 days in the current year in the U.S.,
OR
You spend at least 31 days in the current year in the U.S. and you meet the substantial presence test:
Substantial Presence Test - Formula:
Add all the days you spent in the U.S. in the current calendar year;
plus
1/3 of the days you spent in the U.S. last year;
plus
1/6 of the days you spent in the U.S. in the year before
If when using the formula above your total equals at least 183 days, you are considered a U.S. resident alien for U.S. tax purposes in the current year.

You are a U.S. NON-resident alien – Quick reference box
You are a U.S. non-resident alien if you spend:
Less than 31 days in the U.S. in the current year,
OR
At least 31 days in the current year but you do not meet the substantial presence test.



There are two possible options to qualify for relief from U.S. resident alien status and having to file a U.S. resident income tax return. You may be able to claim what is called a "closer connection exception" or a "treaty exemption".

You are Considered a U.S. Resident Alien – What are Your Options?

If you are considered a U.S. resident alien under the substantial presence test, there are two possible options to qualify for relief from U.S. resident alien status and having to file a U.S. resident income tax return. You may be able to claim what is called a "closer connection exception" or a "treaty exemption".

Claim the Closer Connection Exception – For Canadians Who Spent Less Than 183 Days in the U.S. in the Current Year

If you meet the substantial presence test but you spent less than 183 days in the U.S. in the current year you may claim the closer connect exception to be considered a U.S. non-resident. You will not have to file a U.S. resident tax return and pay U.S. tax on your worldwide income if you claim a closer connection exception.

To claim the closer connection exception you must complete U.S. form 8840 - Closer Connection Exception Statement for Aliens and show that you have a closer connection with Canada. The following factors would indicate a closer connection with Canada:

The following factors would indicate a closer connection with Canada:

- The location of your permanent home is in Canada;
- Your family is located in Canada;
- You are carrying on a business in Canada;
- You own personal property in Canada such as a car, furniture, or jewellery;
- You hold a Canadian drivers license;
- You have memberships in social organizations in Canada ;
- You are registered and vote in Canada;
- You belong to religious, political or cultural organizations in Canada; and
- You have a bank account in Canada.

For further information on Form 8840 you can refer to the form and filing instructions, which are available on the IRS website at **http://www.irs.ustreas**.gov/ or speak to your tax advisor.

The filing requirements, deadlines and penalties for failure to file are discussed later.

Claim a Treaty Exemption – For Canadians Who Spent Over 183 Days in the U.S. in the Current Year

If you spent over 183 days in the U.S. in the current year or applied for or held a U.S. green card you cannot claim the closer connection exception. However, you may be able to claim a treaty exemption to be deemed a resident of Canada and thus a non-resident of the U.S. You will not have to file a U.S. resident tax return and pay U.S. tax on your worldwide income if you claim a treaty exemption.

To claim a treaty exemption, you must be deemed to be a resident of Canada under the provisions contained in the Canada-U.S. Income Tax Convention (treaty) called the "treaty tie breaker rules". You are considered to be a resident for tax purposes by each country's domestic tax rules; however, the treaty tie breaker rules may be used to ultimately determine which country you are deemed a resident of for income tax purposes.

If the first treaty tie breaker rule demonstrates that you have a permanent home available for your

If you were present in the U.S. for more than 183 days and meet the substantial presence test you may also need to file Form 8938, *Statement of Foreign Financial Assets* and Form TDF 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*.

use only in Canada you will tie break to Canada. If you have a permanent home available for your use in both Canada and the U.S., then you have to look at the second treaty tie breaker rule, which looks at where your centre of vital interests (i.e., your personal and economic ties) are closer. Examples of where your centre of vital interests are closer to Canada are if your family is located in Canada, you are carrying on a business in Canada, your bank accounts, social memberships, religious organizations are located in Canada, you are registered and you vote in Canada. If your centre of vital interests are closer to Canada and you do not have these same ties in the U.S., you will tie break to Canada. If you tie break to Canada under the treaty provisions, you will be considered to be a deemed resident of Canada and thus deemed a non-resident of the U.S. and therefore can claim a treaty exemption. You must file a non-resident U.S. tax return (i.e. 1040NR) and attach a treaty exemption statement (Form 8833), which indicates that you are a resident of Canada under the treaty.

If you were present in the U.S. for more than 183 days and meet the substantial presence test you may also need to file Form 8938, *Statement of Foreign Financial Assets* and Form TDF 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*. Even if you make the treaty exemption to be treated as a non-resident alien for income tax purposes, you may still need to file these forms.

Form TDF 90-22.1 is required if at any time in the year the aggregate value of foreign bank and financial accounts you own, have an indirect interest in, or have signing authority over, exceeds US $10,000. Examples of foreign bank and financial accounts are Canadian bank or brokerage accounts, registered retirement and education savings accounts (RRSPs, RESPs), locked-in retirement accounts (LIRAs, LIFs, LRIFs and PRIFs) and Tax-Free Savings Accounts (TFSAs).

Form 8938 is required only if you have to file a U.S. income tax return and the aggregate value of "specified foreign financial assets" (i.e. foreign financial accounts, foreign securities, any interest in foreign entities, any financial instruments or contracts with a non-U.S. counter party or issuer, foreign private equity and interest in privately held foreign entities) exceeds certain thresholds that depend on your filing status. For example, if you are single, or not filing a joint return with your spouse, you may meet the reporting thresholds if the total value of your specified financial assets is more than US $50,000 at the end of the calendar year or $75,000 at any time during the calendar year. However, if you meet certain criteria to be considered "living abroad" the reporting thresholds increase to US $200,000 and US $300,000 respectively. If you are filing a joint U.S. income tax return with your spouse, these thresholds increase further.

For further information on Form TDF 90-22.1 or Form 8938 you may refer to the form and filing instructions, which are available on the IRS website at **http://www.irs.ustreas.gov/** or speak to your tax advisor.

The filing requirements, deadlines and penalties for failure to file are discussed next.

Filing Requirements, Deadlines and Penalties

Filing Requirements Depend on Your U.S. Residency Status

The following summarizes the filing requirements for each of the scenarios described in this article:

You Do Not Meet the Substantial Presence Test – But Did You Earn U.S. Source Income?

If you spent less than 31 days in the U.S. in the current year or you spent at least 31 days in the U.S. in the current year but you do not meet the substantial presence test you will be considered a U.S. non-resident alien.

You do not need to file a U.S. non-resident income tax return if you have not earned any U.S. source income. However, if you earned certain types



If you complete and file Form 8840 you will be considered a U.S. non-resident alien for U.S. tax purposes.

of U.S. source income you will be required to file a U.S. non-resident tax return (1040NR). For example, if you earn U.S. wages (regardless of whether any U.S. tax is withheld at source) you must file a U.S. non-resident tax return; however, if you earn only U.S. dividends the withholding tax is generally deducted at source and provided the correct amount is withheld you do not need to file a U.S. non-resident tax return.

You Meet the Substantial Presence Test and You are Claiming the Closer Connection Exception:

If you meet the substantial presence test as discussed above but you were present in the U.S. for less than 183 days in the current year you can claim the closer connection exception so that you are not considered a U.S. resident alien.

If you complete and file Form 8840 you will be considered a U.S. non-resident alien for U.S. tax purposes. Form 8840 is mailed directly to the U.S. tax authorities unless you are required to file a U.S. non-resident tax return, in which case Form 8840 must be attached to and mailed with your U.S. non-resident tax return.

The requirement to file a U.S. non-resident tax return depends on the type of U.S. source income you earn. For example, if you earn U.S. wages (regardless of whether any U.S. tax is withheld) you must file a U.S. non-resident tax return; however, if you earn only U.S. dividends the withholding tax is generally deducted at source and provided the correct amount is withheld you do not need to file a U.S. non-resident tax return. The requirement to file a U.S. non-resident tax return depends on the type of U.S. source income you earn. For example, if you earn U.S. wages (regardless of whether any U.S. tax is withheld) you must file a U.S. non-resident tax return; however, if you earn only U.S. dividends the withholding tax is generally deducted at source and provided the correct amount is withheld you do not need to file a U.S. non-resident tax return.

You Meet the Substantial Presence Test and You are Claiming a Treaty Exemption:

If you meet the substantial presence test and you were present in the U.S. for at least 183 days in the current year you cannot claim the closer connection exception but you may claim the treaty exemption as discussed above so that you are not considered a U.S. resident alien.

You must file a U.S. non-resident tax return (1040NR) and attach a completed Form 8833 to it to claim the treaty exemption. You will report and pay tax only on U.S. source income.

If you meet the substantial presence test and were a present in the U.S. for more than 183 days you may also need to file Form 8938, *Statement of Foreign Financial Asset*s and Form TDF 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)* as discussed earlier.

Deadlines and Penalties

If you are required to file Form 8840, Form 8833 or Form 8938, these forms are filed together with your U.S. non resident income tax return, which is due by June 15th of the following year. Note that if you have earned income that was subject to U.S. withholding, such as U.S. employment income, your filing deadline is April 15th of the following year.

If you do not file an income tax return or pay the tax that is due, the IRS may levy a failure-to-file penalty and a failure-to-pay penalty. Each of these penalties is calculated based on a percentage of the income tax liability

If you do not file Form 8840 by the due date, it would mean you have to file a U.S. resident income tax return instead of a non-resident income tax return.

that remains unpaid. The failure-to-file penalty may be as high as 25% of the unpaid tax. The failure to pay penalty is 0.5% for each month the amount is unpaid. The IRS may also charge interest on the unpaid tax.

It is important to be aware that if you do not file Form 8840 by the due date, it would mean you have to file a U.S. resident income tax return instead of a non-resident income tax return. Although you could technically claim a treaty exemption, you may still be subject to non-disclosure penalties under the IRS tax laws, which could amount to as much as $1,000 for each item of income involved.

If Form 8938 is not filed by the due date of your income tax return, you could be subject to an initial penalty of US $10,000. If you receive a notice from the IRS and you do not file within 90 days of this notice, you could be subject to additional penalties of US $10,000 for every 30 days that pass, up to a maximum additional penalty of US $50,000.

Form TDF 90-22.1 is not mailed with your income tax return. It is mailed separately to the Department of the Treasury and must be received on or before June 30th of the following year. There are no extensions to file available for this form. A penalty of up to US $10,000 can be levied for failure to properly file this form. In addition, if you wilfully fail to report an account or account identifying information, you may be subject to a greater penalty equal to the greater of US $100,000 or 50 percent of the balance in the account at the time of the violation.

The treaty does not protect you from these penalties.

Conclusion

You should consult with a tax advisor familiar with Canada-U.S. tax laws to determine your U.S. residency status. They can help you determine if your situation qualifies for relief under the closer connection exception or the treaty exemption and provide you with assistance in completing the necessary U.S. filings.

Please contact us for more information about the topics discussed in this article.

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