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## 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. tax and reporting obligations on your worldwide income 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 avoid the status of U.S. resident alien and thus avoid the requirement to file a U.S. resident tax return (Form 1040). However, failure to understand the U.S. tax obligations imposed by the IRS can 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 and potential ways to avoid U.S. tax and reporting obligations associated with being considered a U.S. resident alien. 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.*

### 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.

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If a Canadian resident holds a U.S. green card or meets the substantial presence test, they will be considered a U.S. resident alien and will be subject to tax in the U.S., similarly to a U.S. citizen. This includes having to file a U.S. tax return and pay tax on their worldwide income, including Canadian source income, as well as being entitled to the same deductions and personal exemptions available to U.S. citizens.

If a Canadian resident does not hold a U.S. green-card and does not meet the substantial presence test they will be considered 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 really depends 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 while 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 and no U.S. tax return is required.

Note that there will be 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 residents aliens filing a U.S. resident tax return.

## Determining U.S. residency status under the substantial presence test

The substantial presence test is used for individuals who are not U.S. citizens and green-card holders in determining U.S. residency status under U.S. domestic tax laws. The following explains the two-step test that U.S. non-resident aliens (excluding green card holders) must satisfy to meet the substantial presence test and be considered 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?

The first part of the test is to determine if you were physically present in the U.S. for at least 31 days in the current year. If you were not, you can stop here as you will not be considered a U.S. resident alien for this particular year. Instead, you are considered a U.S. non-resident alien for tax purposes and as explained earlier depending on the type of U.S. source income you earn you are either subject to U.S. withholding at source only or you must file a U.S. non-resident tax return.

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

If you were present in the U.S. in the current year for 183 days or more you automatically meet the substantial presence test and do not need to go to step 2. If you were present for more than 30 days but less than 183 days, go to step 2 to complete the test.

**Step 2:** Does the weighted 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?

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## 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 you meet step 1 and step 2 - that is, 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, you will be considered a U.S. resident alien.

If you do not meet the substantial presence test you are considered a non-resident alien which means you either spent less than 30 days in the U.S. in the current year or you spent between 31-182 days in the U.S. in the current year but do not meet the three year formula above.

## Substantial presence test calculation example

If you spent 130 days in the U.S. in each of 2008, 2009, and 2010, your calculation to determine whether you are considered a U.S. resident alien for the 2010 tax year would be as follows:

You spent at least 31 days in the U.S. in 2010 and over the three years the formula results in 195 days of presence in the U.S. (i.e., this year's 130 days plus last year's 130 days divided by 3 plus 2008'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 **do** meet the substantial presence test in 2010.

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 you will be considered a U.S. resident alien.

## **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.

## **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 you may still qualify for relief in two ways by claiming 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 and you spent less than 183 days in the U.S. in the current year you may claim the closer connect exception and be considered a U.S. non-resident and avoid the requirement to file a U.S. resident tax return and pay U.S. tax on your worldwide income.

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To claim the closer connection exception you must show, by completing U.S. form 8840 - Closer Connection Exception Statement for Aliens, that you have 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
- You have a Bank account in Canada

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 would be filed with your U.S. non-resident tax return. Form 8840 and instructions for completing and filing can be downloaded from the IRS website <http://www.irs.ustreas.gov/>. The filing requirements, deadlines and penalties for failure to file are discussed below.

## **Claim a treaty exemption – For Canadians who spent over 183 days in the U.S. in the current year**

If you spend more than half the year in the U.S. you **cannot** claim a closer connection exception since you will have spent more than 183 days in the U.S. in the current year. The same is true for those who hold or have applied for a U.S. green card. However, you may still be able to avoid having to file a U.S. resident tax return and pay U.S. tax on your worldwide income if you are able to claim a treaty exemption and be considered a U.S. non resident alien.

Although you are considered a resident of both Canada and the U.S. under each country's domestic tax laws, you can use provisions contained in the Canada-U.S. Income Tax Convention (treaty) called the "treaty tie breaker rules" 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 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 center of vital interests (i.e., your personal and economic ties) are closer. If your center of vital interests are closer to Canada, for example, 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, and you do not have these same ties in the U.S. you will be considered a deemed resident of Canada and thus deemed a non-resident of the U.S. under the treaty.

In this case, you would 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. You will report and pay tax only on U.S. source income.



## 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 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 and you were present in the U.S. for less than 183 days 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.

#### **You meet the substantial presence test and you are claiming a treaty exemption:**

If you meet the substantial presence test but you were present in the U.S. for at least 183 days 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.

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## Deadlines and Penalties

Form 8840 to claim the closer connection exception and Form 8833 together with your U.S. non resident income tax return must be filed 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.

Also important to be aware of is that if you do not file Form 8840 by the due date it would mean you have to file a U.S. tax return and 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. 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.



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