Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

U.S. income tax and other filing requirements for U.S. persons living in Canada

Please note that this article assumes you are a U.S. person (i.e. a U.S. citizen or U.S. resident, including a U.S. green-card holder) living in Canada. If you're not sure whether you're considered a U.S. person, please ask an RBC advisor for a separate article that discusses that topic.

The U.S. tax system imposes income tax based on both citizenship and residency status. U.S. persons living outside the U.S are required to file income tax returns in the U.S., on an annual basis, irrespective of their tax status in the country they live in. This article provides information regarding the common U.S. income tax and other U.S. filing requirements that apply to U.S. persons living in Canada.

The U.S. tax system imposes income tax based on both citizenship and residency status. U.S. persons living outside the U.S are required to file income tax returns in the U.S., on an annual basis, irrespective of their tax status in the country they live in. This article provides information regarding the common U.S. income tax and other U.S. filing requirements that apply to U.S. persons living in Canada.

Your U.S. income tax liability

U.S. persons who are Canadian residents also have an obligation to file a Canadian income tax return and pay Canadian income taxes. While both countries impose tax on your worldwide income (i.e., income from all sources worldwide), their income tax legislation differs, as do their filing requirements. As such, it is important to understand the different filing requirements.

As you are liable for taxes in both countries, you may face double taxation. You may be able to claim foreign tax credits (FTCs) to reduce or eliminate double taxation. Further,

the Canada-United States Tax Convention, (Treaty) may allow you to claim additional FTCs or deductions. In order to benefit from the Treaty, you may be required to file various income tax and information returns in both countries, annually.

Here's an example of when FTCs can help mitigate your exposure to double taxation. Let's assume you earn employment income in Canada (i.e., all your workdays were in Canada). Canada generally has the first right to impose income tax on that income. While you have an obligation to file a U.S. income tax return, which would include your Canadian sourced employment income, a FTC may be claimed related to the Canadian sourced employment income on your U.S. income tax return. The FTC may reduce or eliminate your U.S. income tax liability by the amount of Canadian income tax paid.

If, on the other hand, the income you earn is U.S. sourced (i.e., all your workdays were in the U.S.) and your employer is located in the U.S., the U.S. has the right to tax the income first and a FTC may be claimed on your Canadian income tax return for the U.S. income tax paid.

For U.S. income tax purposes, foreign income and FTCs are categorized into separate "baskets" based upon the type of foreign source income. For example, foreign taxes related to foreign employment income and foreign investment income would generally be placed into separate baskets. However, if the foreign tax on investment income exceeds the highest U.S. tax rate, the income would then be "kicked out" into the general limitation basket, along with employment income.

The foreign income and foreign taxes from one basket, generally, cannot be combined with or offset against the foreign income and foreign taxes from another basket. For example, the foreign income tax related to employment income, generally, cannot be used to reduce the tax liability related to foreign investment income.

The risk of double taxation for a U.S. person who is a resident of Canada is usually low. This is because Canadian income tax rates are generally higher than those imposed under the U.S. income tax legislation and the higher Canadian income tax rates are also applied at much lower income thresholds. Generally, a foreign tax credit associated with Canadian income tax incurred will normally offset your U.S. income tax liability and no double tax will likely result. Therefore, when the same employment income is taxed in both countries, your combined U.S. and Canadian income tax rates will usually be reflective of the higher of the two countries' income tax rates (i.e., often the Canadian income tax rate).

You may still incur a U.S. tax liability because there are differences in each country's income tax laws for income recognition and allowed deductions and credits.

In the event, your Canadian income tax liability and the associated FTC exceed your U.S. income tax liability, the U.S. tax laws allow for the excess FTC to be accumulated in the respective baskets. The excess FTCs may be used to reduce the U.S. income tax liability that you incurred in a prior year or over the next 10 years on foreign income related to the respective baskets.

For U.S. income tax purposes, there is also the option to claim an exclusion or deduction of a certain portion of your employment income earned from foreign sources (e.g., Canadian source employment income). The exclusions and deduction are referred to as the "foreign-earned income exclusion" and the "foreign housing exclusion or deduction". Information on how to qualify for these exclusions or deductions is not discussed in this article; however, it is important to point out that if you choose to claim them, you cannot claim a FTC on the portion of the foreign taxes related to the amounts deducted or excluded from your taxable income when filing your U.S. income tax return.

In general, if you live in a high tax country such as Canada, it may be more beneficial to claim FTCs instead of claiming the deduction or exclusions. A qualified cross-border tax advisor can determine whether it is more tax-efficient to claim the deduction and/or exclusion versus the FTC.

The FTC system and the interplay between both countries is complex. Generally, if your income is primarily earned in Canada, your U.S. income tax liability after applying the possible exclusions, deductions or FTCs may be eliminated. However, it is also possible that you may still incur a U.S. tax liability because there are differences in each country's income tax laws for income recognition and allowed deductions and credits.

Whether you have a U.S. income tax liability or not, you are still required to file a U.S. income tax return, when you meet the U.S. minimum tax filing requirements for the particular year.

U.S. Net Investment Income Tax (NIIT)

The U.S. introduced a 3.8% net investment income tax (NIIT) applicable in 2013 and subsequent tax years.

The NIIT applies to your net investment income when your total gross income, as modified under the NIIT rules, (the complexity of which is beyond the scope of this article) is in excess of certain thresholds. For example, U.S. persons who are married and file their U.S. income tax return jointly are subject to the 3.8% NIIT on their net investment income to the extent the value of their combined modified adjusted gross income (as defined under NIIT) exceeds US$250,000. For married individuals filing separately, the threshold is $125,000, and for those filing single, the threshold is US$200,000.

Your net investment income is your investment income less your investment expenses. Investment income includes items such as interest income, dividend income, capital gains, annuity income, royalty income, rents and other passive income from all sources (not just U.S. source). Investment expenses include items such as investment interest paid, rental expenses incurred, and your income tax preparation fees.

U.S income tax law does not allow you to claim a FTC to offset NIIT.

Talk to a qualified tax advisor about planning strategies to minimize your exposure to the NIIT. For example, if you are married and your spouse is not a U.S. person, your tax advisor may advise you to file your U.S. income tax return status as married filing separately, if your modified adjusted gross income alone is below the threshold or if your non-U.S. spouse (who would not be subject to NIIT) earns most of the investment income.

U.S. federal income tax return filing requirements, deadlines and penalties

For U.S. federal income tax purposes, you must file Form 1040 — *U.S. Individual Income Tax Return* annually.

Normally, you must file your U.S. income tax return for a particular year no later than April 15th of the following calendar tax year end; however, if you reside outside the U.S. on April 15 and your main place of business or employment is outside the U.S., the filing deadline is automatically extended to June 15th. You may also be able to request an additional extension to file your U.S. income tax by October 15th.

If you do not file your U.S. federal income tax return by the due date, the U.S. may impose a late filing penalty.

Regardless of your filing deadline date, any U.S. tax owed must be paid to the Internal Revenue Service (IRS) by April 15th. If you do not pay your income tax by April 15th, the IRS will impose an interest charge and a late payment penalty.

U.S income tax law does not allow you to claim a FTC to offset NIIT.

Each of these penalties may be as high as 25% of the balance due.

Foreign reporting requirements and penalties

U.S. persons are required to disclose information about the various financial assets that they own or have certain authority over that are located outside the U.S. (commonly referred to as foreign financial assets). Such foreign financial assets include, investments in Canadian or other non-U.S. securities held within registered or non-registered investment accounts and bank accounts, a direct interest in Canadian or other non-U.S. entities and trusts. Examples of when you may be considered to have authority over these assets are if you are acting as trustee, power of attorney or signing officer or director.

Various foreign reporting requirements apply to U.S. persons with such foreign financial assets, which are in addition to the requirement to file a U.S. income tax return. Some of the foreign reporting requirements only require disclosure of information and do not levy additional U.S. income tax, but some may result in punitive U.S. income tax and in some cases double tax.

The foreign reporting requirements may include the filing of a report, a statement, or a return, either with your U.S. income tax return or separately. In addition, the foreign reporting filing deadline dates may not coincide with the deadline to file your U.S. income tax return.

You may incur penalties for failure to file or for filing late. Many of the penalties amount to US$10,000 for each account, occurrence or filing form. However, higher civil and criminal penalties may apply for wilful failure to file.

A table is provided, in Appendix A, which lists some of the more common examples where U.S. persons have foreign reporting requirements for U.S. income tax purposes. The table provides general information only and is not an exhaustive list; therefore, you should consult with a qualified cross-border tax advisor for more information on the foreign reporting requirements that may apply to you.

Foreign Account Tax Compliance Act (FATCA)

The Foreign Account Tax Compliance Act (FATCA) was legislated in 2010. By way of an Inter-Governmental Agreement (IGA) between the Canadian government and the IRS, the Canada Revenue Agency (CRA) will collect certain information, which is in turn exchanged with the IRS.

FATCA requires non-U.S. financial institutions, such as Canadian brokerage firms and banks, to report relevant information about certain financial accounts held by U.S. persons to the CRA.

For more information, ask an RBC advisor for a separate article discussing FATCA.

Voluntary disclosure for U.S. nonfilers

In the interest of encouraging all U.S. persons to be compliant with their U.S. income tax and information return filing requirements, the IRS has implemented various voluntary disclosure programs over the years. Such programs provide methods by which noncompliant taxpayers, whether they live in the U.S. or not, can get up-to-date on their U.S. income tax and other filings. Depending on the program(s) in effect at the time, a certain number of previous year's U.S. income tax returns and U.S. foreign reporting returns must be filed with the IRS.

While, there may be little or no U.S. income tax owing on your annual U.S. tax return due to the deductions and FTCs discussed earlier, there may be substantial penalties and, in some cases, criminal proceedings associated with wilful failure to comply with your U.S. tax and filing obligations.

If you are not filing annual U.S. income tax returns or other required filings, you should speak to a qualified tax or legal advisor regarding your options.

U.S. state filingrequirements

In addition to federal income tax reporting requirements, a U.S. person may have state reporting requirements. State filing requirements may arise if you have maintained your domicile in a state that taxes based on domicile, or if you have income from sources within that state, such as income from work days in a particular state. Since each of the 50 states have different requirements, you should consult with your tax advisor whether you are subject to state reporting.

Although you are living in Canada, as a U.S. person, you continue to be subject to U.S. income tax filing and reporting requirements.

Summary

It is important to be aware that although you are living in Canada, as a U.S. person, you continue to be subject to U.S. income tax filing and reporting requirements. In addition to having to file a U.S. income tax return, the U.S. tax law imposes various other foreign reporting requirements that may also apply to you.

Since you are subject to both Canadian and U.S. tax laws, it is important to speak to a qualified cross-border tax advisor before you implement any type of tax planning based on the income tax laws of one country because it may be in conflict with the income tax laws of the other country. This may lead to unexpected tax consequences, such as double tax.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified cross-border tax, legal, and/or insurance advisor before acting on any of the information in this article.

Appendix A: Examples of foreign reporting requirements for U.S. persons

The following table lists some of the more common foreign reporting requirements that may apply to U.S. persons. This table provides general information only and is not an exhaustive list of all the possible foreign reporting requirements under U.S. income tax laws. You should consult with a qualified cross-border tax advisor for more information on the foreign reporting requirements that may apply to you.

Examples	Description	Report
U.S. persons with non- U.S. bank and financial accounts	A foreign reporting requirement may arise when a U.S. person owns (whether solely or jointly), has an indirect interest in, or has signing authority over, a non-U.S. bank or financial account when the aggregate value of all these accounts exceeds US$10,000 at any time during the year. Examples of non-U.S. bank and foreign accounts include Canadian bank or brokerage accounts, Canadian registered retirement and education savings accounts, Canadian locked-in retirement accounts and Canadian tax-free savings accounts.	Report of Foreign Bank and Financial Accounts (FBAR) (FinCen Report 114)
U.S. persons with non-U.S. financial assets	A foreign reporting requirement may arise when a U.S. person invests in certain non-U.S. financial assets (referred as specified foreign financial assets) and the aggregate value of these assets exceeds certain thresholds. Examples of specified foreign financial assets include Canadian bank or brokerage accounts, Canadian registered retirement and education savings accounts, Canadian locked-in retirement accounts and Canadian tax-free savings accounts. For U.S. persons living in Canada who do not file a joint tax return with their spouse, the threshold is US$200,000 at the end of the calendar year or US$300,000 at any time during the calendar year. For U.S. persons living in Canada who file a joint tax return with their spouse, the thresholds are US$400,000 at the end of the calendar year or US$600,000 at any time during the calendar year.	Statement of Foreign Financial Assets (Form 8938)
U.S. persons who are settlors, contributors or beneficiaries of a non-U.S. trust	A foreign reporting requirement may arise when a U.S. person has transactions with a foreign trust (e.g., Canadian trust) or an interest in a foreign trust and/or is responsible for reporting certain transactions associated with the foreign trust. Examples include a U.S. person who is the settlor of, contributor of property to, or the beneficiary of a non-U.S. trust.	Information Return of Foreign Trusts with a U.S. Owner (Form 3520-A) Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520)
U.S persons who are in receipt of certain gifts/ inheritances from non-U.S. persons	A foreign reporting requirement may arise when a U.S. person is in receipt of gifts or bequests of more than US$100,000 from a non-U.S. person. Foreign reporting may also apply to certain gifts from a non-U.S. corporation or partnership that exceeds certain thresholds.	Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520)
U.S. persons who are shareholders of certain passive non-U.S. investments	A foreign reporting requirement may arise when a U.S. person directly or indirectly owns a non-U.S. investment that qualifies as a Passive Foreign Investment Company (PFIC) for U.S. income tax purposes. In general, a PFIC is a non-U.S. corporation, or an investment that is categorized as a non-U.S. corporation that primarily invests in passive assets or earns passive income. Examples include Canadian mutual funds, Canadian Exchange Traded Funds (ETFs) and Canadian Real Estate Investment Trusts (REITs)	Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund (Form 8621)

Examples	Description	Report
U.S. persons who are shareholders of certain non-U.S corporations	A foreign reporting requirement may arise when a U.S. person is an officer, director or shareholder of certain non-U.S. corporations. Examples include a U.S. person who is a shareholder of a Canadian corporation that qualifies as a Controlled Foreign Corporation (CFC) under U.S. income tax laws. In general, the CFC is a non-U.S. corporation that is controlled by a U.S. person(s) by votes or value.	Information Return of U.S. Persons with Respect to Certain Foreign Corporations (Form 5471)
U.S. persons who have interests in certain non-U.S. partnerships	A foreign reporting requirement may arise when a U.S. person owns an interest in an investment that is classified as a non-U.S. partnership for U.S. federal tax purposes, or has an interest in a partnership formed in a foreign country that meets certain conditions. Examples include a U.S. person who owns 10% or more of a Canadian partnership while it is controlled by U.S. persons or a U.S. person who has contributed property to a partnership with a value of more than US$100,000.	Return of U.S. Persons With Respect to Certain Foreign Partnerships (Form 8865)

Wealth Management

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the “Companies”) and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. “RBC advisor” refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ®/™ Registered trademarks of Royal Bank of Canada. Used under licence. © 2021 Royal Bank of Canada. All rights reserved. NAV0232 (01/19)