Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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U.S. residency – Canadians travelling to the U.S.

U.S. income tax residency rules may affect you

If you're a Canadian who spends substantial time in the U.S., you may be required to file a U.S. income tax return and may have other U.S. filing obligations. Being aware of U.S. income tax laws and the obligations imposed by them may help you prevent unpleasant surprises and costly penalties.

This article provides a basic overview of U.S. residency under the U.S. income tax laws, the circumstances where U.S. income tax and reporting obligations may arise and the options available if you're considered a U.S. income tax resident.

Any mention of "Canadian" in this article refers to a Canadian resident who is not a U.S. person for income tax purposes (i.e. U.S. citizen or U.S. green card holder).

U.S. residency and U.S. tax obligations

The basis for U.S. income taxation is U.S. citizenship and U.S. residency. If you're a Canadian who is not a U.S. citizen, you may be a U.S. income tax resident if you're a U.S. green card holder or you meet the substantial presence test. If you are a U.S. income tax resident, you may be subject to U.S. income tax and have other U.S. reporting obligations, similar to a U.S. citizen. This may include having to file a U.S. income tax return (IRS Form 1040) as an income tax resident of the U.S. and paying tax on your worldwide income (including Canadian source income). You will also be entitled to the same deductions and personal exemptions available to U.S. citizens. In addition, you may have to file other U.S. forms that require you to disclose information such as financial accounts you own that are located outside of the U.S.

Canadians who meet the substantial presence test have options under U.S. tax rules and under the Canada-U.S. Income Tax Convention (Treaty),

described later, to qualify for various forms of relief from the obligations of U.S. residency status. However, if you choose to claim relief under the Treaty, you may still have to file certain U.S. forms generally required by U.S. citizens and residents.

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

If you're not a U.S. citizen or green card holder, the substantial presence test may deem you to be a U.S. resident.

Condition 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 automatically do not meet the substantial presence test. You are not a U.S. income tax resident.

If you were present in the U.S. for 183 days or more in the current year, you automatically meet both conditions of the test and would be a U.S. income tax resident for U.S. tax purposes.

If you were present for more than 30 days but less than 183 days, you need to go through condition 2 to determine whether you meet the test.

Condition 2: Does the total number of days you spent in the U.S. over the last three calendar years equal or exceed 183 days based on the following formula?

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. in the previous calendar year (i.e. first year before the current year);

plus

1/6 of the days you spent in the U.S. in the calendar year before the previous year (i.e. the second year before the current year).

If the total number of days using this formula amounts to 183 days or more, you meet the substantial presence test. You are a U.S. income tax resident for U.S. tax purposes for the current year.

If the total number of days using this formula amounts to less than 183, you do not meet the substantial presence test. You are not a U.S. income tax resident for U.S. tax purposes.

If you were present in the U.S. for 183 days or more in the current year, you automatically meet both conditions of the test and would be a U.S. income tax resident for U.S. tax purposes.

When counting the number of days present in the U.S., even if you're 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. However, there are certain exceptions. 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 the days you were in transit in the U.S. for less than 24 hours while travelling between two places outside of the U.S. (e.g. you have a layover in Chicago on your way to Uruguay). Certain individuals such as foreign government officials, students and teachers or trainees may exempt days of presence in the U.S. if they're temporarily present under certain visas and comply with the requirements of that visa. Talk to a qualified tax advisor for more information on how to count your days of presence in the U.S. for tax purposes.

Substantial presence test example

Assume you spent 130 days in the U.S. in each of the last three years. Let's see if you meet the two conditions under the substantial presence test for the current year:

Since you spent at least 31 days in the U.S. in the current year, you meet the requirements of condition 1. Because you spent less than 183 days in the U.S. in the current year, you must determine if you meet the requirements of condition 2, which looks at the days of presence over the last three years. For condition 2, the formula results in 195 days of presence in the U.S. over the last three years, calculated as follows:

- 130 days in the current year, plus
- 43 days in the previous year (130 days multiplied by 1/3), plus
- 22 days in the year before the previous year (130 days multiplied by 1/6)

Since 195 days (130 days + 43 days + 22 days) is equal to or greater than the 183-days guideline, in this example, you meet the substantial presence test for the current year.

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 to be a U.S. income tax resident.

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

Are you a U.S. income tax resident?

You're considered a U.S. income tax resident (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 will have to do the following calculation using the 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 prior to last year.

If, when using this formula, the total equals at least 183 days, you are considered a U.S. income tax resident for U.S. tax purposes in the current year.

U.S. immigration versus income tax laws

It's important to recognize that there are differences in U.S. immigration laws versus U.S. income tax laws for Canadians visiting the U.S. From an immigration perspective, the U.S. Customs and Border Protection (CBP) generally limits your presence in the U.S. to six months in a rolling 12-month period, or 180 days in a rolling year. Also, the manner in which your days of stay in the U.S. are counted for U.S. immigration purposes may be different. Speak to a qualified legal professional with expertise in U.S. immigration laws for further information.

The U.S. tracks your days of presence in the U.S.

Canada and the U.S. now share information about when you enter and leave your respective country. As a result, the U.S. is able to track your days of presence in the U.S. This information may be used by the U.S. to enforce both U.S. immigration and income tax laws.

The CBP provides online access to a report of your border crossing. To access the information, you will require several pieces of information found on your passport, including country of issuance, passport number, full name and date of birth.

You may claim the closer connection exception to be considered a U.S. non-resident for income tax purposes provided you spent less than 183 days in the U.S. in the current year and you have not applied for or do not hold a U.S. green card.

Options for U.S. income tax residents under the substantial presence test

There are two options to qualify for relief from U.S. income tax resident status. Under U.S. income tax rules, you may be able to claim the "closer connection exception" and under the Treaty, you may be able to claim a "treaty exemption."

Closer connection exception

You may claim the closer connection exception to be considered a U.S. non-resident for income tax purposes provided you spent less than 183 days in the U.S. in the current year and you have not applied for or do not hold a U.S. green card. If you successfully claim this exception, you will not have to file a U.S. resident tax return or other U.S. forms discussed later, and you will not be taxable in the U.S. on your worldwide income.

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 will indicate you have a closer connection with Canada:

- Your permanent home is in Canada;
- Your family is located in Canada;
- Your business activities are carried on in Canada;
- You own personal property in Canada such as a car, furniture or jewellery;
- You hold a Canadian driver's licence;
- 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.

Filing requirements

If you are filing Form 8840 to claim a closer connection to Canada and you are not required to file a U.S. non-resident tax return, you can mail Form 8840 directly to the U.S. tax authorities by its due date of June 15 of the following year. If you're filing a U.S. non-resident tax return, then Form

8840 is attached and filed with your return by its due date of June 15 of the following year. If you were an employee and received wages subject to U.S. income tax withholding, your U.S. non-resident income tax return and Form 8840 would be due by April 15 of the following year.

If you do not file Form 8840 by the due date, you will not be eligible to claim the closer connection exception and may be treated as a U.S. income tax resident, which means you may have to file a U.S. resident income tax return. In this case, you may be able to file a U.S. non-resident tax return and attach a treaty statement claiming a treaty exemption as discussed later. However, you may still be subject to non-disclosure penalties under the IRS tax laws, which may amount to as much as $1,000 for failing to disclose a treaty- based position.

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.gov/ or speak to a qualified tax advisor.

Treaty exemption

If you spent over 183 days in the U.S. in the current year, you may claim a treaty exemption to be deemed a resident of Canada and not a U.S. income tax resident. If you can successfully claim the treaty exemption, you will not have to file a U.S. resident income tax return or pay U.S. tax on your worldwide income; however, you may have to file other U.S. forms discussed later. Talk to a qualified tax advisor regarding your eligibility to make the claim.

In general, to claim a treaty exemption, you must be deemed to be a resident of Canada under the provisions contained in the Treaty called the "treaty tie-breaker rules." You're considered to be a resident for income 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. Here is some general information about the treaty tie-breaker rules. If the first treaty tie-breaker rule demonstrates that you have a permanent home available for your use only in Canada, you may 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 are closer. Your centre of vital interest refers to your personal and economic ties. 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; and you are registered and you vote in Canada. If your centre of vital interests is closer to Canada and you do not have these same ties in the U.S., you may tie break to Canada. If you are treated as a resident of Canada under the Treaty, you are treated as a non-resident of the U.S. in figuring your U.S. income tax and may be eligible to claim a treaty exemption. For purposes other than figuring your U.S. tax, you will be treated as a U.S. income tax resident.

If you spent over 183 days in the U.S. in the current year, you may claim a treaty exemption to be deemed a resident of Canada and not a U.S. income tax resident

Filing requirements

If you claim the treaty exemption to claim U.S. non-resident status for U.S. income tax purposes, youmust file a U.S. non-resident tax return (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.

If you are required to file Form 8833, it is filed together with your 1040NR, which is generally due by June 15 of the following year. If you were an employee and received wages subject to U.S. withholding tax, your U.S. non-resident tax return and the Form 8833 would be due by April 15 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 that remains unpaid. The failure-to-file penalty is generally 5% of the tax owed for each month, or part of a month, up to a maximum of 25% of the unpaid tax. The failure-to-pay penalty is 0.5% for each month, or part of a month, that the amount is unpaid, up to a maximum of 25% of the amount that remains unpaid. The IRS may also charge interest on the unpaid tax.

If you were present in the U.S. for more than 183 days in a particular year, you may be required to complete and file other U.S. forms even if you successfully claim the treaty exemption to be treated as a non-resident for U.S. income tax purposes. An example of a U.S. form you may need to file is the FinCEN Report 114 – *Report of Foreign Bank and Financial Accounts (FBAR)*. This form must be filed electronically and 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 Savings Plans (RRSPs) and Registered

Education Savings Plans (RESPs), locked-in retirement plans (LIRAs, LIFs, LRIFs and PRIFs) and Tax-Free Savings Accounts (TFSAs).

FinCEN Report 114 is not mailed with your income tax return. The Department of the Treasury requires this form to be completed and sent electronically on or before June 30 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 penalty equal to the greater of US$100,000 or 50% of the balance in the account at the time of the violation. The Treaty does not protect you from these penalties.

For further information on filing the Form 8833 or the FBAR, refer to the forms and filing instructions, which are available on the IRS website at http://www.irs.gov/ and speak to a qualified tax advisor regarding these and other filings that may be required. Also, speak with a qualified tax advisor regarding any other U.S. forms you may be required to file.

Monitor your status

It's important to monitor your presence in the U.S. for both U.S. immigration and income tax laws. For U.S. income tax purposes, you should consult with a qualified tax advisor who is familiar with Canada-U.S. income 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.

It's important to monitor your presence in the U.S. for both U.S. immigration and income tax laws.

If you're not a U.S. income tax resident, you're only subject to U.S. income tax on income from U.S. sources. Generally, you do not need to file a U.S. income tax return if you simply earn U.S. investment income, such as U.S. dividend income, since your U.S. tax obligation is generally paid through withholding tax. However, if you sell or earn rental income from U.S. real estate, you may need to file or elect to file a U.S. non-resident tax return. For more information on this topic, please ask an RBC advisor for a separate article discussing Canadians owning and renting U.S. real estate.

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 tax, legal and/or insurance advisor before acting on any of the information in this article.

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