US FATCA FOR CANADIANS

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LETTE is an established international law group with offices in Toronto, Montréal, Paris and Munich, offering a wide range of legal services to the business community. Whether acting for a multinational corporate group or for dynamic entrepreneurs, LETTE provides practical and effective solutions to its clients.

Canada taxes income based on residency. Citizenship is not a factor. Residents of Canada are taxed on their world income. Non-residents are taxed only on the income that is earned in Canada. Tax is paid at both the federal and provincial level.

The United States taxes income based on citizenship and immigrant status rather than residence alone. A "US Person" must report and is taxed by the IRS on world income, regardless of the place of residence.

A "US Person" is:

- a physical person who is a US citizen
- a lawful resident of the USA (*eg.* green card holder) or
- a person residing in the USA.

Consequently, American citizens residing outside of the USA must file US tax returns, regardless of how long they have been residing abroad or how young they were when they left.

Children born outside of the USA to at least one parent who was a US citizen at the time of birth can have acquired US citizenship from their parent and be subject to the same filing obligations, even though the child may never have lived or even set foot in the United States.

Canadian residents who spend much time in the USA, such as Snowbirds, could for income tax purposes be considered to be residents of the USA, if they meet a "substantial presence" test. These Canadian "dual residents" may have USA tax filing obligations.

The obligation to file US tax returns will not necessarily result in any US taxes, since a tax credit is usually granted for income taxes paid outside of the USA on the same. However, failure to file or late filing can result in penalties.

However, in some circumstances, there could be US tax payable that will not be offset by the Canadian taxes.

One reason is because deductions available to reduce taxable income in Canada, such as the exemption for capital gains earned from the sale of a family residence, may not have an equivalent in the USA. A US citizen residing in Canada, could have to pay income tax in the USA on the capital gain from the sale of the family residence, even though this income is exempted from tax in Canada.

This can also apply to some vehicles used to reduce taxable income earned in Canada. For example, the interest earned from sums (up to the eligible yearly limit) in a Tax Free Savings Account, is not taxable income in Canada. However, this interest must be reported to the IRS and constitutes taxable income in the USA. The same applies to interest earned from sums invested in Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) that have not yet been withdrawn. However, US citizens may, in their US tax returns, make an election to defer the tax on the income earned from RRSPs and RRIFs until the sums are withdrawn.

In addition, contributions to RRSPs are not tax-deferred in the USA as is the case in Canada. Consequently, the deductions from net income made in Canada for RRSP contributions must be included in the income reported in the US return. The deferral election mentioned above does not apply to the contributions.

The USA also imposes estate tax on US Persons, which is based on the value of the assets owned at the time of death. A deceased US Person residing outside of the USA is taxed on worldwide assets, even if no assets are located in the USA. Canada does not have an estate tax, however a death can trigger a taxable capital gain, which is declared in the deceased's final tax return, resulting from a deemed disposition of capital assets on the date of death at fair market value. As residents of Canada are taxed on world income, the deemed disposition applies to all property outside of Canada. For non-residents owning property in Canada, the deemed disposition applies only to the Canadian property.

US taxpayers are also required to file a *Report of Foreign Bank and Financial Accounts* ("FBAR"). The FBAR reports are separate from the income tax filings and are filed with the office of Financial Crimes Enforcement Network (FinCEN). Canadian residents with US tax filing obligations are therefore required to file a FBAR to report their Canadian bank and financial accounts, if the FBAR threshold is met, as well as

accounts under which the account holder has signing authority (such as trust accounts held for minor children), if the total sums in all accounts exceed the equivalent of $10,000 US at any time during a year. Very stiff penalties can result from a failure to report accounts. If the failure to report is intentional, the penalties are increased.

In 2010, the USA passed the *Foreign Account Tax Compliance Act* ("FATCA"), which obliges non-U.S. financial institutions to report relevant information to the Internal Revenue Service (IRS), about certain financial accounts held by identified U.S. Persons.

FATCA also requires some US taxpayers with assets outside of the USA to file a new form known as Form 8938 (Statement of Specified Foreign Financial Assets). This form is filed with the annual tax return and does not replace the FBAR obligations, and requires further details on the assets than the FBAR. The threshold for the obligation to file this form is higher than the one for the FBAR and varies in accordance with matrimonial status. The threshold is also higher for taxpayers residing outside of the USA. The threshold for 2015 is $200,000 on the last day of the tax year, or $300,000 at any time during the year for unmarried taxpayers or married taxpayers not filing jointly with their spouses. The threshold is doubled for married taxpayers filing joint returns[1]. As with FBARs, very stiff penalties can result from a failure to report accounts, which are substantially increased where the failure is intentional.

Subsequent to the coming-into-force of FATCA, the USA signed intergovernmental agreements ("IGA") with numerous other countries to enforce compliance by foreign institutions under their local laws. In February 2014, Canada and the USA signed such an IGA, under which the countries agreed to an enhanced mutual exchange of information under the existing Canada-USA tax treaty. Under the IGA, commencing July 1, 2014, Canada agreed to provide information received from its financial institutions on certain accounts held by US residents and citizens. In exchange, the USA agreed to provide CRA with information on US accounts held by Canadian residents. Under the *Canada–United States Enhanced Tax Information Exchange Agreement Implementation Act*[2], this IGA became law in Canada.

[1] https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements
[2] SC 2014, c 20, s. 99

Under amendments to Canadian income tax legislation as a result of the IGA, Canadian institutions are now obligated to report accounts and information on the account holders to Canada Revenue Agency, which in turn provides it to the IRS.

The accounts that must be reported by the institutions include: bank accounts, mutual funds, brokerage accounts, annuity contracts and life insurance policies with a cash value held by a U.S. Persons. Accounts closed on or after July 1, 2014 are included, because the closing of the account does not retroactively release the banks from their reporting obligations with respect to these accounts.

The obligation by US Persons to report these Canadian accounts, if the amounts therein met the FBAR threshold, existed prior to the adoption of the Canadian legislation.

Certain types of accounts are exempted from the reporting obligation by the institutions, including[3]:

- Registered Retirement Savings Plans
- Registered Retirement Income Funds
- Pooled Registered Pension Plans
- Registered Pension Plans
- Tax-Free Savings Accounts
- Registered Disability Savings Plans
- Registered Education Savings Plans
- Deferred Profit-Sharing Plans

However, these reporting exemptions for the institutions do not affect the income tax filing or FBAR and FATCA reporting obligations for US Persons in Canada with respect to these accounts.

Renunciation to US citizenship for US Persons with dual citizenship could be an option to find relief from the obligation of income tax filings and account reporting. Since FATCA, the number of Canadians with inherited US citizenship renouncing same has increased, and the waiting time is very long. In February 2016, the Globe and Mail reported that US Treasury department figures showed an increase in 2015 of renunciations of 43% from 2014, with waiting periods of up to a year[4]. In addition, the process is complex, and fees very high.

[3] Agreement, Annexe II, par. IV (Accounts Excluded from Financial Accounts)
[4] http://www.theglobeandmail.com/news/politics/delays-costs-mount-for-canadians-renouncing-us-citizenship/article28688026/

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In February 2015, the Obama Administration announced proposed legislation in the *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*[5] (these are known as the "Green Book" and are released with the Administration's Budget by the Treasury and provide explanations of the Administration's revenue proposals). These proposed amendments, if passed into law, contain provisions that would end taxation due to citizenship for certain "Accidental Dual Citizens" who renounce their US citizenship and would make the renunciation procedure easier. The Proposal did not become law in 2015 and the provisions for the accidental dual citizens were almost integrally repeated (the only change being the proposed effective date) in the 2017 Green Book[6].

The Proposal acknowledges:

> Individuals who became citizens of both the United States and another country at birth may have had minimal contact with the United States and may not learn until later in life that they are U.S. citizens. In addition, these individuals may be citizens of countries where dual citizenship is illegal. Many of these individuals would like to relinquish their U.S. citizenship in accordance with established State Department procedures, but doing so would require them to pay significant U.S. tax.

The Proposal presently provides:

> … an individual will not be subject to tax as a U.S. citizen and will not be a covered expatriate subject to the mark-to-market exit tax under section 877A if the individual:

1. became at birth a citizen of the United States and a citizen of another country;
2. at all times, up to and including the individual's expatriation date, has been a citizen of a country other than the United States;
3. has not been a resident of the United States (as defined in section 7701(b)) since attaining age 18½;
4. has never held a U.S. passport or has held a U.S. passport for the sole purpose of departing from the United States in compliance with 22 CFR §53.1;
5. relinquishes his or her U.S. citizenship within two years after the later of January 1, 2017, or the date on which the individual learns that he or she is a U.S. citizen; and
6. certifies under penalty of perjury his or her compliance with all U.S. Federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a non-resident alien during that period.

The proposal would be effective after December 31, 2016.

Relief from the burden of tax filing and account reporting may therefore lie ahead for some Canadians with dual American citizenship facing predicaments of US tax filing and reporting obligations due simply to their parents' choice of their place of birth. Unfortunately, these proposed measures will not benefit any naturalized Canadians, even if they left the USA as young children coming to Canada with their parents. An exception to the exception may however offer the same relief, if the Proposal is accepted as drafted, for those born in the USA to a Canadian parent and thereby may have inherited Canadian citizenship.

5 https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf
6 https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf

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Luise Bauer
Lette & Associés S.E.N.C.R.L.
630, Bd. René-Lévesque Ouest,
Bureau 2800
Montréal, QC H3B 1S6
T: +1 514-788-0996
E: lbauer@lette.ca