

March 2002

The U.S. TAXFAX

TOPIC: U.S. FILING REQUIREMENTS FOR U.S. CITIZENS LIVING IN CANADA

This edition of *The U.S. TAXFAX* will discuss a few of the issues that a U.S. citizen living in Canada must consider when filing their 2001 U.S. return.

Who must File?

Regardless of the country in which they reside, U.S. citizens are obligated to file a Form 1040, U.S. Individual Income Tax Return, if their **gross income** exceeds certain minimum thresholds based on their filing status. The thresholds for 2001 are as follows:

<u>Marital Status</u>	<u>Age</u>	<u>Gross Income</u>
Single	<65	\$7,450
	>65	\$8,550
Married spouse not filing or spouse is not a U.S. resident		\$2,900
Married, living with spouse, and filing jointly	<65	\$13,400
	>65 (one sp)	\$14,300
	>65 (both sp)	\$15,200

Form 1040 must report the U.S. citizen's worldwide income from all sources. Gross income means all sources of income including income that can be excluded as in the case of the foreign earned income exclusion (discussed later on).

When is the Tax Return Due?

The due date for filing the 2001 Form 1040 is April 15, 2002. However, an automatic two month extension of time is available for U.S. citizens who have a tax home outside of the U.S. on April 15.

The filing due date can also be extended to August 15, 2002 if the necessary form is filed by the original due date for the return. An extension relieves the taxpayer of late filing penalties but does not extend the date for payment of tax. Any unpaid tax for 2001 should be paid by the original due date of the return.

What if the U.S. citizen has not filed?

Many U.S. citizens living abroad are not aware of the requirement to file U.S. income tax returns. The IRS has stated that they will not criminally prosecute anyone who voluntarily files delinquent U.S. tax returns before the IRS contacts them. If an individual has not filed returns for many years, or even never filed returns, the IRS will generally accept six-years of returns to bring the individual current. The IRS has indicated that taxpayers who file past due returns may qualify for several types of penalty relief if the taxpayer can demonstrate reasonable cause for their failure to file.

Miscellaneous Topics:

The following items require special attention when preparing tax returns for U.S. citizens residing in Canada.

Foreign Earned Income Exclusion - This election allows U.S. citizens living abroad to exclude up to US\$78,000 of foreign source earned income on their U.S. return. Earned income includes income from an office or

employment, as well as income from self employment. *It does not include pension income or retirement benefits.* An individual whose tax home is in Canada can only claim the exclusion if he or she meets one of the following requirements:

- is a bona fide resident of Canada for an uninterrupted period that includes an **entire** tax year. This means that individuals moving to Canada can not claim the exclusion in the year of move unless they can qualify under the next provision.
- is physically present in Canada for at least 330 full days during any period of 12 consecutive months, beginning or ending in the current tax year.

We generally suggest that an individual not use the earned income exclusion if U.S. tax liability can be eliminated by means of the foreign tax credit. One reason for this is that foreign taxes related to excluded income are not available as a foreign tax credit. By not claiming the earned income exclusion, an individual can quickly build up a large pool of foreign tax credit carryovers due to the disparity between Canadian and U.S. tax rates. This may be beneficial for a variety of reasons, one of which is if the U.S. citizen intends to move back to the United States and will continue to earn Canadian source income.

Canada – U.S. Tax Treaty Considerations – A U.S. citizen with U.S. source income must consider Article XXIV of the Treaty. This Article states that Canada will not allow a foreign tax credit on U.S. source income of a U.S. citizen in excess of that which would have been paid by a non resident of the U.S. on the same income. This article often results in a variety of adjustments relating the allowable foreign tax credits on the U.S. and Canadian returns. We have noticed an increasing number of cases where CCRA has picked up on these adjustments and reassessed the Canadian return.

Alternative Minimum Tax (AMT) – U.S. citizens living in Canada often have an AMT liability even though they do not have a regular tax liability.

The most common reason is that for AMT purposes a U.S. citizen's foreign tax credit claim is restricted to 90% of the AMT liability. Therefore, regardless of the Canadian taxes paid by the U.S. citizen, a tax of at least 10% of the AMT liability will be due if income is above the AMT exemption amount. It is important the U.S. AMT provisions be considered when preparing returns for U.S. citizens living in Canada.

Canadian Corporations – U.S. citizens should be made aware of the tax consequences and compliance headaches associated with having a Canadian corporation. U.S. tax legislation includes a variety of punitive sections relating to foreign (e.g. Canadian) corporations with U.S. shareholders. Double tax can be the result of poor planning in this area. The IRS also has large penalties at its disposal for those not complying with the various reporting requirements.

Non U.S. Bank Accounts – The IRS requires disclosure of non U.S. bank accounts on a prescribed form if the cumulative amount held in all the accounts exceed \$US10,000 at any time in the year (these accounts include RRSP's). The IRS also has substantial penalties at its disposal for non-compliance in this area.

Registered Retirement Savings Plans - U.S. citizens may elect to defer taxation on income accrued in their registered retirement savings plans by making an election under Article XVIII(7) of the Canada-U.S. Tax Treaty. A statement must be attached to the return providing the IRS with certain information regarding the RRSP account. Records should also be maintained to track contributions so that the correct amount of U.S. income can be determined at the time a distribution is made.

We recommend that if there are enough foreign tax credits available to offset the tax incurred, any income earned by RRSPs in the year be reported currently. By reporting these earnings, the individual is not taxed on the amount reported when the earnings are distributed.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained herein.