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INTRODUCTION

This paper discusses the taxation of U.S. citizens living in Canada. This includes some of the U.S. tax incidents that follow that residency which gives rise to deferred items of income. The paper also discusses the U.S. tax treatment of Canadians who, for U.S. tax purposes, are treated either as resident or non-resident aliens.

U.S. Taxation of U.S. Citizens Living in Canada

The United States taxes the world-wide income of its citizens. This is true even for U.S. citizens living outside the United States. In this respect, the United States exercises a longer tax grasp than is pursued by most countries.

Two forms of relief are available which limit the degree of double taxation to which U.S. citizens are exposed. The main form of relief is the foreign tax credit which provides a direct offset against a U.S. taxpayer's tax liability for taxes paid in a foreign country on foreign source income.[1] Because the United States has a broad series of statutory rules governing the source of income, it is important to identify the source of income in order to be certain that the foreign tax credit is in fact applicable to protect items of income from juridical double taxation. This element has become even more important since conflicts may arise between treaty provisions and newly adopted statutory provisions.[2]

The second form of relief is an exclusion from taxable income of the foreign earnings of qualified individuals living outside the United States.[3] This provision exempts $70,000 earned income, prorated on a daily equivalence basis,[4] plus an amount for housing from U.S. taxation.[5] As an anti-abuse provision the excluded amount cannot exceed the individ-

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[1] I.R.C. § 901 (1988).

[2] I.R.C. § 901 (1988); *id.* at § 7852(d); H.R. Con. Res. 93, 100th Cong., 1st Sess. (1988).

[3] I.R.C. § 911 (1988).

[4] I.R.C. § 911(b)(2)(A) (1988).

[5] I.R.C. § 911 (c) (1988).

ual's foreign earned income for the year.[6]

To become a qualified individual, one must either be a U.S. citizen residing outside the United States as a bona fide resident of a foreign country for a period of one full taxable year, or be a U.S. citizen or resident of the United States absent from the United States for at least 330 days in any twelve consecutive month period.[7] An individual will fail the U.S. "bona fide resident" test if he asserts to the Canadian authorities that he is not subject to their income tax, and simultaneously claims to the U.S. authorities, that he is a bona fide resident of Canada. This could happen with an individual who moves among several foreign countries outside the United States.

In the Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital[8], the issue of residence is governed by Article IV. Article IV sets out a fairly comprehensive scheme for determining the taxpayer's country of residence, which provides that the ultimate determination of residency will be made by the competent authorities of the two countries.[9] A U.S. citizen's assertion that he is not a resident in Canada may hinder his bona fide residence argument with the U.S. authorities.[10] However, where the individual is exempt from Canadian tax on another basis, it is likely that the assertion of that condition will not defeat the residency position.[11]

A portion of housing costs incurred for foreign housing may also be treated as excluded from taxation. The amount allowed for the housing cost allowance is sixteen percent of the Step 1 level of a GS-14 (the present level of this amount is $7,775).[12] The amount may not exceed the earned income of the individual.

There are rather complex rules that govern the inclusion of amounts paid in the years other than the year in which the income is earned. The general rule is that if an individual receives compensation in the year after the year in which it was earned it may be carried back to that year if there is capacity in that year for additional exclusion.[13] For example, an individual has earned income for 1988 of $65,000 and in the next year receives a bonus for 1988 of $10,000 and salary for 1989 of $68,000. $65,000 plus $5,000 of the bonus would be claimed in 1988. An amended

6 I.R.C. § 911(d)(7) (1988).

7 I.R.C. § 911(d)(1) (1988).

8 Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, United States-Canada, — U.S.T. —, T.I.A.S. No. —, — U.N.T.S. — (not in print, *reprinted in* BROWN, THE NEW CANADA-UNITED STATES INCOME TAX TREATY 279-309 (PLI) (1984) [hereinafter TREATY].

9 *Id.* art. IV, para. 2(d).

10 I.R.C. § 911(d)(5) (1988).

11 *Citizens and Resident Aliens Employed Abroad*, Tax Mgmt. (BNA) No. 13-3d, at A-9 (Feb. 12, 1990).

12 I.R.C. § 911(c)(1)(B)(i); 5 U.S.C. § 5332 (1988).

13 I.R.C. § 911(b)(1)(B)(iv) (1988).

return might be needed for 1988. The remaining $5,000 cannot be used as foreign earned income for 1988.

The foreign tax credit is also available to the individual who qualifies for the foreign earned income exemption. To prevent the taxpayer from obtaining an unintended benefit in respect of his other income, the rules prohibit claiming foreign tax credit on the income that has been protected by the exclusion.[14] The regulation that governs this calculation enumerates a formula whereby the foreign tax paid or payable on earned income is multiplied by a fraction, the numerator of which is the amount excluded under the statutory exclusion less the amount of the deductions properly allocated thereto and the denominator of which is the total foreign earned income less the expenses properly allocated thereto. If income other than earned income is taxed by the foreign government, and that income cannot be separated from the earned income, then the denominator of the fraction must include that income and the expenses properly allocated to that income.[15] If such "unearned income" can be segregated then presumably the tax associated with that income would be directly segregated before making the calculation. For this purpose any housing allowance included in the exemption is treated as a deduction directly related to the excluded foreign earned income. Because of the operation of the deduction allocation rules, the limitation of the use of the foreign tax credit is substantially greater than the operation of the provision would otherwise suggest.

Canadians Subject to U.S. Taxation

For U.S. income tax purposes there are two classes of individuals who are not U.S. citizens but are subject to tax: resident and non-resident aliens. Basically, resident aliens are taxed on their world-wide income, as are U.S. citizens.[16] Non-resident aliens are taxed on their income arising from their presence in the United States. A "green card" holder will be treated as a resident alien so long as he holds the green card irrespective of the place of residence.[17] This treatment has both positive and negative effects. Even if an individual is not present in the United States, he remains subject to the U.S. tax on his world-wide income. However, the fact that an individual is subject to the tax means that he may remain eligible for U.S. employee benefit plans. This would not be true for a non-resident alien, or a resident alien whose residence was terminated by failure to meet the physical presence test. The exclusion of up to $70,000 in foreign earnings provided to U.S. citizens is also available to a resident alien living outside the United States.

The "substantial presence" test requires that the individual be pres-

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[14] I.R.C. § 911(d)(6) (1988).

[15] Treas. Reg. § 1.911-6(c)(1) (1990).

[16] Treas. Reg. § 1.871-1(a) (1990); *id.*at § 1.1-1(b).

[17] I.R.C. § 7701(b)(1)(A)(i) (1988).

ent in the United States for at least 183 days in the year.[18] This test gives the taxpayer an opportunity to plan whether to be a resident or non-resident alien at least during the first year of substantial presence in the United States. An alien who does not arrive before July 2nd will not be treated as a resident alien for the year, absent a green card. An alien's incidental presence of ten days or less will be disregarded if, during those ten days, the individual has stronger ties to Canada.[19]

The substantial presence test is complicated by the aging process for determining 183 days presence over a three year period. Using all of the days present in the current year, one-third of the days present in the preceding year and one-sixth of the days present in the year preceding that, an alien who has a total of 183 days present will be treated as a resident alien.[20] Using the calculation, an individual who meets the 183 day test and does not have a clear tax home in Canada or elsewhere would be determined to be a resident. This rule permits an individual to be present in the United States for up to 121 days each year without running afoul of the 183 day test (e.g., 1990: 121 days, 1989: 121/3 = 40.3 days, 1988: 121/6 = 20.2 days, totaling 181.5 days).

The purpose of this rule is to prevent taxpayers from leaving the United States for a period of less than three years to avail themselves of some tax planning device. The resident alien is entitled to the same deductions, credits and exemptions as a citizen, so he bears the same burdens, but has the same benefits, in the area of income taxation as the citizen. To the extent that he has paid foreign taxes, including taxes to Canada he may claim a credit for those taxes.

From an income tax viewpoint the most troublesome position arises in the deferred compensation area, where an item may be recognized under Canadian law at the time of grant and then subsequently be recognized in the United States at the time of receipt. In such cases, the full burden of double taxation can befall the transaction with disastrous effect. Both countries have the right to tax the transaction, and there is no treaty protection because the Canadian portion of the tax falls in a period of Canadian residency and the American portion falls during the period of residency in the United States, with no protection from the foreign tax credit. Relief may be obtained through the route of competent authority, but such relief is by no means certain. It is worthwhile to consider completing the transaction before entering the United States, or deferring its completion until well after returning to Canada. In addition, it is important in such instances to document the fact that none of the incidents of the benefit were related to U.S. services.

Generally speaking, the Treaty takes care of most transactions by allocating them to the country of residency. For a taxpayer caught be-

[18] I.R.C. § 7701(b)(3)(B)(i) (1988). *See* TREATY, *supra* note 8, art. XV, para. 2(b).
[19] I.R.C. § 7701(b)(2)(C) (1988).
[20] I.R.C. § 7701(b)(3)(A)(ii) (1988).

tween two countries, each having significant tax rates, it is most important that taxation be limited to one country or the other on a definite basis. Canada's withholding of taxes that may be levied on dividends or interest would be credited to the United States resident in determining U.S. tax liability. Under U.S. law, since the 1986 changes, different forms of income, such as wages or dividends on portfolio investments, fall into different categories.[21] This prevents the utilization of excess credits from one form of income being used to reduce U.S. taxes on other forms of income.

A non-resident alien is confronted by a different set of rules, with their own opportunities and problems. The taxation is limited to full taxation on the income derived from work performed in the United States if one of two tests is met. A Canadian non-resident is taxable under the Treaty only if earnings from his employment in the United States exceed $10,000 or the cost of his employment is borne by a U.S. employer, or by the U.S. permanent establishment of a Canadian employer.[22] However, under U.S. tax law the threshold level of compensation is only $3,000.[23]

Transactions entered into outside the United States are not taxable by the United States. Only compensation earned in the United States is taxable, so that if an individual who is subject to taxation as a non-resident leaves the United States during his employment in the United States to perform services in a third country, such services would not be subject to taxation in the United States.

Taxes levied on services and taxes levied on items such as interest and dividends are treated separately in determining the liability of non-resident aliens.[24] Taxes due on general investment type income, not associated with a permanent trade or business in the United States, are subject to tax by withholding by the payor. If the payor is properly notified, the withholding rate is reduced under the terms of the Treaty. The withholding tax rates under the Treaty are 15% for general investors,[25] and 10% where the beneficial owner of dividends holds at least 10% of the voting stock of the issuing corporation.[26] For purposes of determining the taxable income of a non-resident alien individual deductions are allowed only to the extent they are related to the income-producing activity of the individual. Ordinarily, the non-resident alien is allowed but one personal exemption in determining his income. However, in the case of Canadians, as for U.S. citizens, the full exemption rule applies.[27]

For non-resident aliens an interesting problem arises with respect to

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21 I.R.C. § 904(d) (1988).

22 TREATY, *supra* note 8, art. XV, para. 2(a).

23 I.R.C. § 861(a)(3)(B) (1988).

24 TREATY, *supra* note 8, arts. X-XVI.

25 *Id.*, art. X, para. 2(b).

26 *Id.*, art. X, para. 2(a).

27 *International Aspects of U.S. Withholding on Wages and Service Fees*, Tax Mgmt. (BNA) No. 462, at A-19 (1985) [hereinafter *International Aspects of U.S. Withholding*].

moving expenses. If an individual moves for a period of less than one year, then the moving expense allowances do not apply. However, in such an event, the travel expense rules do seem applicable and expenses incurred for travel to the United States and expenses of maintaining the individual would qualify as a deductible business expense. The Internal Revenue Service takes the position that an assignment lasting longer than a year is an indefinite assignment and that the travel expense rules do not apply to expenses incurred during an indefinite stay.[28] If, on the other hand, the individual will remain in the United States for a period beyond one year, then moving expenses are deductible. Reimbursement to the individual for such costs must be counted as income. Travel expense account items may be exempt from reporting if the employer reimbursing the expenditure requires an adequate accounting for the amounts and activities.[29]

Social Security Taxes

When an individual is employed in the United States he is subject to the tax imposed under the Federal Insurance Contributions Act ("FICA").[30] Unfortunately, most individuals working in the United States without a green card will not be present for the necessary forty quarters required to qualify for a retirement benefit under the U.S. Social Security system.[31] A convention between the United States and Canada was entered into to avoid the double application of social security taxes on the same wages.[32] The basic rule is the "place of work" rule, which enforces the social security tax for the country in which the individual works.[33] However, there is a major exception which treats a person sent to the United States by a Canadian employer as subject to Canadian instead of United States taxation.[34] This rule applies so long as the assignment is for a period of less than sixty months. Even where the period of the assignment exceeds sixty months, there is a possibility of obtaining an exemption from the proper authorities. Furthermore, as a practical matter it is difficult to keep a non-green card individual in the United States beyond the sixty month period because of visa restrictions imposed by the U.S. immigration authorities.

A U.S. citizen sent to Canada remains subject to the U.S. FICA requirements during the first five years of a Canadian assignment. A U.S. citizen going to Canada to work without being sent becomes subject to

28 Rev. Rul. 83-82, 1983-1 C.B. 45.

29 Treas. Reg. § 1.274-5(e)(2)(i) (1990).

30 I.R.C. § 3101-3128 (1988).

31 42 U.S.C. § 414(a)(2) (1988).

32 Agreement with Respect to Social Security, Aug. 1, 1984, Canada-United States, T.I.A.S. No. 10863.

33 *Id.* art. V, para. 1.

34 *Id.* art. V, para. 2(a).

the Canadian tax. Unfortunately, such individual may also be subject to the U.S. FICA tax in spite of the Treaty.

Withholding Taxes

A U.S. citizen working abroad for a U.S. taxpayer is subject to wage tax withholding.[35] Such a taxpayer, qualifying for the $70,000 exclusion is entitled to avoid withholding on that amount.[36] Moreover, he may use a Form W-4 to take into account other items which might reduce his withholding tax from what it would otherwise be. Such items would include personal exemptions, or exceptional deductions that would reduce the normally expected tax on income. This would include the special housing cost exclusion that is allowed in conjunction with the $70,000 exclusion.[37]

A U.S. citizen who lives abroad for a short period of time can expect to have his overseas living expenses treated as a deduction, and thus reduce the amount of his withholding taxes and ultimate tax liability. However, in the situation of an individual who is on an assignment for more than twelve months (and cannot meet the substantial presence test because of frequent trips back to the United States and who does not become a bona fide resident of the foreign country) the $70,000 exclusion will not apply and living expenses will not qualify as deductible travel expenses. In such an event, full taxation will apply to salary and living expenses and withholding taxes will apply to the entire amount. In either case, if the foreign tax that is applied is in excess of the U.S. rate on the same income, the aggregate tax liability may not change. Allowance can be taken on the Form W-4 for the amount of foreign tax credit that is available to the individual.

A Canadian resident in the United States who works outside the United States is entitled to the same treatment as a U.S. citizen under the Treaty's non-discrimination clause.[38] There is a question about whether a Canadian can qualify under the bona fide resident rule. However, at least one commentator has stated that he probably can.[39]

A resident alien is entitled to use a Form W-4 to reduce his withholding tax on wages, although a non-resident alien may not.[40] The reduction may amount to a total avoidance of withholding taxes if the individual had no U.S. tax liability for the preceding year and has apparently no liability for the present year. As a practical matter the non-discrimination provisions of the Treaty make it possible to take into account the $70,000 exclusion, although technically this is not correct. So

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35 I.R.C. § 3402 (a) (1988).
36 I.R.C. § 3401(a)(8)(A)(i) (1988).
37 I.R.C. § 3401(a)(8)(A)(i) (1988).
38 TREATY, *supra* note 8, art. XXV, para. 1.
39 *International Aspects of U.S. Withholding, supra* note 27, at A-20.
40 *Id.* at A-29.

long as the tax withheld does not result in an underpayment of tax that would give rise to a penalty it is unlikely that the IRS would press the technicality. It also is not clear whether it is appropriate to use the Form W-4 to take into account the foreign tax credit that would be available on a resident alien's foreign source income. The use of the Form W-4 to limit withholding to the level needed to satisfy the ultimate tax liability is not likely to result in a serious problem. In any of these areas, however, caution must be exercised.

For instance, the taxpayer and employer must remember that the foreign tax credit for a taxpayer claiming the $70,000 exclusion is limited. If the claim results in an underpayment that leads to a penalty, clearly the taxpayer has a problem, and it is possible that the employer may have a problem too. This highlights an underlying issue in this area: Often an employer of transborder employees takes on responsibility for taxes in excess of what would have been paid in the home country if the individual had not been transferred. Tax treatment planning at the withholding level, as well as at the ultimate liability level, should be carefully coordinated. The reimbursement policies often make transborder employment extremely expensive, impairing the efficiency of international operations. The cost of the transborder employment, together with immigration problems, clearly impede the free flow of talent in the international organization.

The issues with respect to a non-resident alien are somewhat different. Generally, a non-resident alien is restricted to one exemption, [41] and may not use the Form W-4 to reduce the otherwise applicable withholding. For Canadians it is possible to claim personal exemptions for dependents, but it is not appropriate to claim additional exemptions for deductions. This means that if the individual has items such as unreimbursed expenses that will be deductible on the tax return (Form 1040NR) no recovery of those items can be achieved until the return is actually filed. Because of the prejudice against the non-resident alien in the withholding mechanism, it is unlikely that withholdings will be under estimated. In such a case estimated tax payments are required to meet the minimum pay-as-you-go standards.[42]

If the employer of a Canadian who becomes subject to U.S. income taxes and wage tax withholding is a U.S. citizen, the problem in the business context is relatively simple. Business organizations in the United States are likely to have a payroll tax system that meets the requirements of Federal and State law. However, Canadian firms without U.S. operations will find the establishment of a system to take care of the obscurities of U.S. payroll taxation relatively onerous. It makes sense to develop a way to include the person in the payroll of a U.S. operation. As an alternative, it may be wise to establish either a branch of a separately incorpo-

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[41] Treas. Reg. § 31.3401(a)(6)-1(A) (1990).

[42] *International Aspects of U.S. Withholding, supra* note 27, at A-21.

rated Canadian corporation or a U.S. subsidiary corporation to manage this problem. Such a proposal raises concerns of the parent corporation over whether it has established another permanent facility or created a presence sufficient to subject it to long-arm jurisdiction. In both instances questions arise regarding the applicability of the U.S. judicial system for issues of liability.

Deferred Compensation

For payments by a U.S. employer to a U.S. citizen living outside the United States, tax and withholding calculations are relatively easy. The income is included in the employee's wages and is subject to wage tax withholding, and probably subject to FICA and FUTA taxes, if the other compensation of the employee is subject to such taxes. If the amounts are paid for services rendered while in the United States then the source is domestic. If, however, the payment is for services rendered outside the United States, then the source is foreign. Both the earned income exclusion and the foreign tax credit may apply. Of course, both cannot apply to the same dollars.

If, on the other hand, the payment is made to a non-resident alien things become more complex. If the amount is paid for services rendered outside the United States, then the amount is non-taxable in the United States and no withholding tax applies. If the amount is paid for services rendered in the United States, the basic tax liability does attach and withholding consequences follow under a variety of scenarios. If, in the year of payment the employee is working in the United States, then the amount is taxed at the appropriate graduated rate.[43] Withholding taxes apply at the twenty percent rate for special payments.[44] This is true even if the employee ceased to work in the United States and moved abroad during the year.

An impractical solution applies if the employee is outside of the United States for the entire year in which the payment is made. A tax rate of thirty percent is applied, and no treaty provision appears to provide any relief. The withholding rate that is applied still seems to be the twenty percent rate because the amount is treated as treated as wages for tax withholding purposes. With the U.S. statutory tax rates ranging from fifteen to thirty-three percent on a graduated basis, the person may wish to have a sufficient business presence in the United States to permit the filing of a Form 1040NR using the graduated rates. If the thirty-three percent rate applies then there may be a case for remaining outside the jurisdiction for the entire year. The solution is a pure mathematical determination, but it must take into account any other U.S. tax that presence in the United States may trigger.

For the resident alien the problem is essentially the same as for the

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43 Treas. Reg. § 31.3402(c)-1 (1990).

44 Treas. Reg. § 31.3402(b)-1 (1990).

U.S. citizen. It is probably better to pay such obligations before the citizen of Canada comes to the United States, otherwise there is the risk of the United States asserting that the amount, or part of the amount, applies to services rendered in the United States. The taxpayer may find that both governments assert that the income was earned in its country and is fully or partially taxable without the benefit of the foreign tax credit.

Estate and Gift Taxes

For a Canadian working in the United States, or contemplating transferring his residence to the United States, it is important to consider the consequences of U.S. estate and gift taxes. It is unlikely that the federal tax will have significant effects on small estates. However, for individuals with larger asset holdings, including life insurance policies, it is a wise precaution to do some estate tax planning. Resident aliens are subject to U.S. estate and gift taxation on world-wide assets. Since Canada no longer has an estate tax, the U.S. tax is an extra imposition and steps should be taken before a Canadian becomes a U.S. resident to minimize tax effects.