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I Taxation of Canadians Living, Working or Investing in the United States*

I * Copyright ©2026 by Mark T. Serbinski CA (Ont.), CPA (Ont.), CPA (Illinois & Florida) Mr. Serbinski is a Chartered Accountant/Chartered Professional Accountant practicing in Ontario and a partner in the firm of Serbinski Partners PC, Chartered Professional Accountants, Toronto, Ontario as well as a Certified Public Accountant licensed in Illinois and Florida, and a practitioner in the firm of Serbinski Accounting Firms, PC, Certified Public Accountants in Chicago, Illinois. Admitted to practice before the Internal Revenue Service, Mr. Serbinski practices international tax and acts as a consultant to the profession. Further information is available at <https://www.serbinski.com>.

1.01 Introduction

While Canada imposes income taxes on residents of Canada, the income tax system in the United States is based on either citizenship or residence. Therefore, Canadians who live or work in the United States may find themselves subject to taxation on their world income in both Canada and the U.S. The income tax system in the U.S. is administered by the Internal Revenue Service, and is considered one of the most complex systems of taxation in the world and many legal reporting and compliance requirements are considerably different from those in Canada.

Exemption from income taxation in the U.S. because of provisions contained in the Canada-United States Income Tax Convention, 1980 and the subsequent Protocols (Fifth Protocol – effective 2008 is the latest) does not result in an exemption from filing an income tax return. Failure to file U.S. income tax forms and

elections in an accurate and prescribed manner and on a timely basis may result in a denial of the exemption being sought (therefore possibly resulting in double taxation if the person is also taxable in Canada), denial of otherwise deductible expenses, interest, and penalties for inaccurate, incomplete or non filed forms or returns. The sections which follow are intended to provide a very brief summary only of some of the income tax topics relevant to Canadians in the U.S. and do not constitute a complete analysis of the tax law and planning opportunities available. Accordingly, competent international tax advice should be sought prior to acting on any of the information contained herein.

1.02 U.S. Income Taxation of Residents & Citizens

(a) Taxation of Individuals

Individuals who are citizens or residents of the U.S. are taxed on their income from all sources, both within and outside of the U.S. Form 1040 (U.S. Individual Income Tax Return) must be filed with the Internal Revenue Service, each year by April 15, for the prior calendar year. Unlike taxation in Canada, form 1040 may be filed either by an individual separately, or by a married couple on a joint basis. Income tax rates are graduated, and different rate schedules are used for returns with different filing status. In this way, income tax rates are adjusted to account for differences in circumstances for persons filing as single, married filing jointly, married filing separately, qualifying widow(er), or as head of household (HOH).

Long Term Capital Gains Rates for 2025

Bracket	Single	Joint	HOH
0%	\$48,350	\$96,700	\$64,750
15% under	533,400	600,050	566,700
20% over	533,400	600,050	566,700

For tax years ending in 2025, the maximum tax rates for non-corporate taxpayers' net capital gains are as shown in the above table.

Ordinary Income Tax Rates for 2025:

Bracket	Single	Joint	HOH
10%	11,925	23,850	17,000
Start 12%	11,926	23,851	17,001
Start 22%	48,476	96,951	64,851
Start 24%	103,351	206,701	103,351
Start 32%	197,301	394,601	197,301
Start 35%	250,526	501,051	250,501
Start 37%	626,351	751,601	626,351

Generally, a U.S. citizen living anywhere in the world, must file a return if the minimum income indicated for the filing status below is met in 2025:

Filing Status	Amount
Single	\$ 15,750
Single (over 65)	17,750
Head of household.....	23,625
Head of household, over 65	25,625
Married filing jointly	31,500
Married filing jointly, one over 65	33,100
Married filing jointly, both over 65	32,300
Married filing separately	0

(b) Itemized Deductions and Standard Deduction

Individuals filing as U.S. residents must choose whether to claim the standard deduction, or whether to itemize deductions. Itemized deductions include such items as medical expenses, state and local taxes, charitable contributions and investment expenses.

For 2018 and subsequent years, itemized deductions are severely restricted while the standard deduction has been substantially increased for both single individuals and a married couple. Further, personal exemptions have been eliminated.

The phase out of itemized deductions at higher income levels has also been eliminated.

The result of these changes will likely reduce the number of taxpayers who itemize deductions.

(c) When Returns are Due

If all taxes due are paid by April 15, an application may be made for an automatic extension of the filing deadline of form 1040 to October 15, and further extensions may be available in certain circumstances. U.S. citizens (or permanent residents) living outside the U.S. (and with no U.S. source employment or self employment income) have until June 15 each year to file their returns and pay taxes, without filing an extension.

Additional filings are required with the 1040 return for holdings of controlled foreign corporations (form 5471). Foreign grantor trusts such as Canadian Tax Free Savings Accounts (TFSA) and Registered Education

Savings Plans (RESP's) must file form 3520 with the 1040 return, and form 3520A by March 15 unless an available six month extension to September 15 is applied for before the initial due date.

U.S. citizens are also required to disclose foreign financial assets on U.S. Treasury form FINCEN 114, electronically by the (extended) due date of the 1040 return and form 8938, which is filed with the 1040 return.

(d) Medicare Taxes

(i) Net Investment Income Tax

Net Investment Income Tax (NIIT) of 3.8% is payable on investment income for higher-income taxpayers. The NIIT applies to the lesser of net investment income or the excess of modified adjusted gross income (MAGI) over the applicable threshold: \$200,000 (single or head of household), \$250,000 (married filing jointly) or \$125,000 (married filing separately). The tax is reported on Form 8960.

Net investment income will include gains from property held for investment, such as stocks, bonds, mutual funds, etc., including gains on the sale of a principal residence in excess of the exemption amount, less expenses related to investments. For NIIT purposes, net losses from property dispositions cannot be less than zero (and therefore cannot offset other investment income), and are not available for carry forward to future periods.

(ii) New Medicare Tax on Earned Income

Additional medicare tax of 0.9% of earned income in excess of the same income thresholds as for NIIT, and are reported on form 8959. Generally, employers are required to withhold the additional tax from pay exceeding \$200,000 per year, but a problem may result from combining income from separate jobs, or spouse's income on a joint return.

(e) U.S. Taxation of Self Employed Persons

Persons carrying on an unincorporated business as a sole proprietor or disregarded entity (such as a single member LLC, for example) in the U.S. are generally subject to income tax on their gross income less allowable deductions attributable to that income, and must file Schedule C with their form 1040 for each business, each year. Self employed persons are also subject to the Self Employment Tax, which amounts to 15.3% of self employment income up to \$176,100 (for

2025), and is imposed in addition to any income taxes payable. The Self Employment Tax is used to fund social security taxes, and is the equivalent of the self employed Canada Pension Plan amount payable in . One half of self employment tax is deductible from income prior to the calculation of tax liability.

Generally, under the terms of Binational Social Security Agreements (or Totalization Agreements), self employed persons who are subject to dual taxation are only required to pay social security taxes or their equivalent in the country in which they reside. Accordingly, U.S. citizens resident in Canada are required to pay Canada Pension Plan (CPP) premiums and are therefore exempt from Self Employment Tax.

Permanent Establishment Defined:

The definition of "permanent establishment" was subject to much interpretation in the former Treaty. Under the new rules, the application of benefits in many cases is tied to whether a person or company has a permanent establishment in a contracting state. A permanent establishment is now created where an individual spends more than 183 days in the other state in any 12 month period and during that time more than 50% of the gross revenue generated by the business is derived from services rendered in the other state by that individual. A permanent establishment may also be created where services are provided in the other state for more than 183 days in any 12 month period with respect to a project for a resident of the other state.

Proportional Taxation:

Consistent with changes in the definition of "permanent establishment" mentioned above, the blanket exemption from taxation available to individuals or businesses providing business services in the other state (but not through a permanent establishment) has been repealed. Now, "business profits" are taxable in each state on a basis proportional to the activity carried out through a permanent establishment in each state.

This now means that any Canadian resident self employed individual or corporate entity which meets the above definition of "permanent establishment" will not be exempt from taxation but will be proportionally taxable in the United States on the net income earned while conducting business in the U.S..

***(f) Partnerships, Rental Income,
Trust and Royalty Income***

Although partnership income is reported on form 1040 - Schedule E each partnership operating in the U.S. must file a separate tax return each year on form 1065. The partnership distributes its income, expenses and other items to partners on form K-1.

Rental and royalty income are also disclosed on Schedule E. A U.S. resident who files Schedule E which discloses rental income from sources in Canada or elsewhere must use U.S. rules in the determination of income and expenses, which in many cases can be significantly different from the rules used in Canada.

Whereas losses from real estate rentals are generally deductible against other income in Canada, Canadian rules prohibit the claiming of capital cost allowance (depreciation) to create or increase a loss from real estate. In the U.S., losses may be created by claiming depreciation, (and depreciation calculations are mandatory rather than elective) but the deductibility of the losses may be limited or deferred by the "passive activity loss" rules.

Net income from rental, royalty or other passive (i.e. interest, dividends, investment) activities may give rise to the requirement to pay quarterly installments of federal (and/or state) tax in advance for the next taxation year.

(g) Taxation of Corporations

Corporations carrying on business in the U.S., whether incorporated in the U.S. or elsewhere, must file a return of income each year within four and one half months for "C" corporations after their fiscal year end (unless extended), and two and a half months after the year end for other entities and must use the appropriate form depending on whether the entity is a Limited Liability Company (LLC), Subchapter S corporation or other entity. Corporations (except flow through entities) pay income tax at a flat rate of 21% commencing in 2018.

Non U.S. corporations that are controlled by "U.S. persons" must be reported on form 5471 on the personal income tax returns of certain shareholders.

Corporate tax planning in the United States is considerably different than that in Canada, since rules are in place to prevent the accumulation of income in excess of \$150,000 for corporations engaged in technical, scientific or professional activities or \$250,000 for others.

***(h) Qualified Business Income
Deduction (QBID)***

To level the playing field and to provide unincorporated entities with a similar tax rate as that available for C corporations, sole proprietors, partnerships, S corporations and REIT's may deduct 20% of qualified business income.

The QBID is available to any business which is not a "Specified Service Business". A Specified Service Business is any business involving the performance of services in the fields of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services where the principal asset is the reputation or skill of one or more of its employees or owners.

(i) Identification Numbers

Commencing with the 1996 taxation year, every individual who files a U.S. income tax return must have a valid identification number issued by the Social Security Administration and acceptable to the IRS. For U.S. residents, citizens, and visa holders entitled to work in the U.S., a Social Security Number (SSN) is required, and is available by completing form SS-5 (Application for a Social Security Card). For spouses, dependents and non-residents who file a U.S. tax return or are claimed as dependents on a U.S. tax return but are not permitted to work in the U.S., an Individual Taxpayer Identification Number (ITIN) is required, and is available by completing form W-7 (Application for IRS Individual Taxpayer Identification Number). Effective in 2012, the Certifying Acceptance Agent program has been eliminated, and all new applications must be accompanied by an original certified copy of a passport, issued by the home country passport office. Tax forms which do not have the appropriate identification numbers will not be accepted by the IRS, and claims for dependents without appropriate numbers will be disallowed. ITINs issued before 2013 and not used in three years may need to be re-applied for starting in 2016.

Partnerships, corporations and self employed persons should apply for an Employer Identification Number (EIN) by filing form SS-4 (Application for Employer Identification Number).

(j) State Taxes

Many states in the U.S. have independent income tax systems applicable to persons living in or earning income from within the state or corporations doing business in the state. Although many states that impose an income tax use the federal taxable income as a starting point, rates, methods of taxation, rules of computation and filing requirements vary from state to state and from entity to entity.

Many states do not recognize foreign tax credits for taxes paid to foreign countries or provinces. As a result, proper tax planning should be undertaken prior to establishing residence in a state to take into account the implications of state taxation as it is complicated by federal and international taxation. Please contact us to determine the foreign tax credit status in a state you are planning to reside in.

1.03 The Importance of Determining Residence

Since both Canada and the U.S. impose an income tax on residents based upon their world income and since both countries have income tax laws dealing with the taxation of non residents, it is important to understand the role that residence plays in determining the liability for income tax.

(a) U.S. Residence Rules

(i) Green Card Test

Under U.S. law, persons who satisfy the “green card test”, including anyone who holds a permanent resident visa and others who reside permanently in the U.S. are considered taxable in the U.S. on their world income from the day they obtain their permanent resident status. Green card holders may therefore find themselves or their business interests subject to U.S. tax rules, even if the business activities or controlled business entities are outside the U.S., and foreign corporations may be subject to the Accumulated Earnings Tax, or Personal Holding Company Tax rules in the U.S. due to differences in the income tax planning, distribution.

(ii) Substantial Presence Test

A person who has not established a residence in but who spends a considerable amount of time in the U.S. may find that they are considered residents of the U.S. even if they do not spend 183 days or more in the U.S. in any

given tax year. The time required to meet the substantial presence test is 183 days, counting all of the days in the current year, one third of the days in the first preceding year, and one sixth of the days in the second preceding year.

Year	Days Present	Portion Counted	Days Included
2024	130	1/1	130
2023	126	1/3	42
2022	72	1/6	12
Total			184

Table 1 – Substantial Presence Test

The person whose situation is illustrated in Table 1 meets the substantial presence test, but may apply for exception from the substantial presence test rule by filing form 8840 (Closer Connection Exception Statement) to prove that they have closer ties to Canada than to the U.S. In order to qualify for exception, the Canadian resident must be able to establish that the usual indicators of residence (i.e. drivers license, club and religious affiliation, income, etc.) indicate stronger ties to Canada than to the U.S.

Many Canadians file form 8840 by itself with the IRS in Philadelphia as a protective measure each year, and Canadians who have U.S. source income and are required to file form 1040 NR file form 8840 along with the form 1040 NR.

(b) Canadian Residence Rules:

(c) Residents of Canada

Surprisingly, there is no specific definition of residence in the Canadian Income Tax Act, but residence is determined as a question of fact. Primarily, any person who spends more than 183 days in any year in Canada is considered a resident. In other cases the court system in Canada has held that the residence of an individual is the place where he customarily lives. In determining residence, such factors as the following are taken into account:

Permanence and purpose of being outside Canada.

Generally, absences of less than two years are not considered sufficiently permanent to sever residential ties with Canada for tax purposes.

Residential ties in Canada, including the maintenance of a home, location of dependents, investments, bank accounts, health coverage, drivers license, club memberships, professional memberships dependent

on residence, personal property, vehicles, social ties, telephone listings, etc.

Residential ties abroad, including visa status outside Canada, income, occupation and social ties. If a Canadian has not established a domicile in another country, he may be considered to have maintained Canadian residence. The type and duration of visas have a role in this factor.

Regularity and length of visits to Canada, can establish continued residence in Canada.

Although visa status in the U.S. by itself will not determine Canadian residence, and even though immigration rules and income tax rules do not always maintain the same definitions of terms, care should be taken not to upset immigration status through an improperly planned elimination of residential ties to Canada. Although persons working in the U.S. under the NAFTA TN visa are expected to be temporary residents of the U.S., they may be non residents of Canada. However, an inability to prove an intention to return to Canada upon the expiry of the visa may affect the determination of visa status or renewal.

(d) Deemed Residents of Canada

Generally, persons who have sojourned in Canada for 183 days or more in any year are deemed to be residents of Canada, and must report world income on their Canadian income tax return for the year. In the year of departure from Canada, both spouses are deemed to be resident in Canada until the date of the latter of the two to depart. Care should therefore be taken to ensure that unplanned periods of tax residence in Canada are not encountered.

(e) Deemed Non Residents of Canada

Under new interpretations of the tiebreaker rule contained in the Treaty, certain persons, after February 25, 1998, are deemed non-residents of Canada if they maintain closer connections to a country other than Canada. Persons in this category would pay tax to Canada only on Canadian source income regardless of the amount of time they spend in Canada.

(f) Residents of Both Canada and the U.S.

Many individuals may find themselves residents of both Canada and the U.S. as a result of the application of the above rules. Under dual residence circumstances, double taxation can be eliminated if filings are made on

a timely and accurate basis, as described in the following section.

1.04 Elimination of Double Taxation

(a) Canada - U.S. Income Tax Convention, 1980

The Canada - U.S. Income Tax Convention, 1980 (Treaty) sets out the rules for foreign tax credits which are available in circumstances where each country claims a right to tax the same income. The Treaty also deals with the treatment to be applied to specific types of income, specific occupations or business endeavors, the determination of residence, and withholding taxes.

By invoking protection under the Treaty, an individual or company claims special exception from taxation under the specific tax laws in either Canada or the U.S. because of a potential for double taxation.

Essentially, the Treaty provides that taxpayers be taxed in their country of permanent residence, unless they have a "permanent establishment" or "fixed base" available to them in the other country. A "permanent establishment" or a "fixed base" has been defined to be an office, a permanent residence, or can be established through the use of an agent who has authority to bind the taxpayer. Under certain circumstances, such as where a part year resident of the U.S. elects to be taxed as a U.S. resident for the entire year, Treaty protection is not available.

It is also important not to claim Treaty protection from U.S. taxation on the basis of residence in situations where a Canadian has obtained permanent resident status in the U.S., since such a statement is inconsistent with and may invalidate the U.S. visa status.

Residents of both Canada and the U.S. may find that their overall income tax liability in any year is not affected by a requirement to file and pay U.S. income taxes, since the operation of the foreign tax credit allows a deduction from Canadian tax to the extent that the same income has been taxed in the U.S.

Canadians who work in the U.S. and are exempt by Treaty from U.S. taxation may apply for exemption from withholding of income and other taxes in the U.S., but must have taxes withheld if their income, time present in the U.S., residence of their employer, or other factors disqualify them from Treaty protection.

(b) Claiming Foreign Tax Credits

Where a resident of Canada is taxed on income earned in the U.S., a claim may be made on the Canadian T1 return for relief from Canadian taxation, but only to the extent that tax was paid on that specific income, and only to the extent of the tax actually paid or payable to the U.S., as limited to the Canadian tax which would be otherwise payable on the same income.

For example, a Canadian resident who files a U.S. 1040 NR return upon which U.S. source employment income was declared, would include the gross amount of the employment income, convert the income to Canadian dollars, and calculate tax on the result. The foreign tax available for credit against the Canadian tax calculated, would be the actual amount of the tax accrued for that employment income after taking into account deductions for all deductible items in the U.S. (Under new rules set out in the Fifth Protocol to the Treaty, ratified on December 15, 2008, deductions for contributions to U.S. pension plans would be also deductible in Canada if other conditions for pension deductibility are met in Canada.) Canadians who move to the U.S. may find that they have paid tax on Canadian source income including rental income in Canada, and must include the rental or other income in their U.S. form 1040 and file form 1116 (Foreign Tax Credit) to claim a foreign tax credit. Under these circumstances, the credit available is restricted to the actual amount of tax paid or accrued on each specific category of income. Foreign income taxes that cannot be used in any year can be used in respect of the same category of income in future periods for a limited time.

(c) Alternative Minimum Tax

The operation of the Alternative Minimum Tax (AMT) rules may sometimes limit the benefit of items otherwise deductible. Under AMT all income items and deductions are re-calculated using AMT rules, and a separate tax rate is applied, subject to the AMT deduction. The tax actually payable in any year is the higher of the tax calculated under the regular rules, and that calculated under the AMT rules. Although the rules for AMT calculation differ in the U.S. and Canada, they operate in a similar manner, and can give rise to a tax liability where no tax would otherwise be payable. In many cases the threshold after which AMT becomes payable is much higher for persons filing as “married filing jointly” than “married filing separately”. As a result an election to treat a non resident alien spouse as a U.S. resident is often used to avoid this issue.

(d)

(e) Totalization Agreement - Social Security

An international agreement respecting social security between Canada and the U.S. sets out the rules for social security taxation for residents of one country working in the other. This agreement, also known as the Totalization Agreement, provides that a Canadian working in the U.S. on a temporary assignment (of up to 5 years) for a Canadian company is exempt from U.S. social security taxes if he remains covered by the Canada Pension Plan (CPP).

In order to prove coverage under the CPP, form CPT 56 must be completed and certified by Revenue Canada. This certified form then acts as the authority not to withhold and remit U.S. social security taxes at source from employment income. A similar exemption is available to self employed Canadian residents who work temporarily in the U.S. (Reciprocal rules are available for U.S. residents working for U.S. companies temporarily in Canada.)

However, Canadian residents employed by U.S. companies in the U.S. are not eligible for relief under the Totalization Agreement. Caution should therefore be used in the transfer of employees to the U.S. to ensure that the transferees remain residents of Canada, and continue to be engaged by the Canadian company (or its subsidiary), since a person would not be covered under the CPP where he/she was considered to be “an employee engaged locally outside Canada”.

Even though all U.S. social security taxes are available as a foreign tax credit to Canadian residents working in the U.S. – resulting in no overall increase in tax to the employee, the benefits of the Totalization agreement are:

If the employee were engaged in the U.S. for 5 years in total, he/she would not be eligible for U.S. social security benefits (since 10 years service are required) – resulting in wasted contributions.

While the employee is working temporarily in the U.S., Canada Pension Plan premiums will continue to be made, and will count toward eventual CPP benefits;

The overall cost to the employer is less, since the 2018 employer portion of U.S. social security taxes is 6.2% of the first \$US128,400 (plus medicare tax of 1.45% without limit), while the employer portion of CPP is 4.95% of \$CDN 52,400 or \$C 2,593.80 (for 2018).

(f) Dual Status Tax Year

A non U.S. citizen who moves into or out of the U.S. in a year, is considered a “dual status alien”, and is taxed

for that year as if the tax year consisted of two periods, one for the time of residence and the other for the nonresident period. Although the income tax liability for the period that the individual is a nonresident alien is determined under the rules relating to nonresident aliens, the taxable income for the year that is subject to the regular graduated tax is determined by combining all income for the period of U.S. residency with any income for the nonresident period that is effectively connected with the conduct of a U.S. trade or business.

A dual status alien cannot claim the standard deduction, but must itemize deductions on his/her income tax return.

The above rules will not apply in cases where a Canadian moves to the U.S. in a tax year, is married to an individual who is a U.S. resident at the end of the year, (i.e., a Canadian spouse moving with him will qualify) and both elect under IRC 6013(g) or (h) to be treated as U.S. residents for the entire year. An alien who moves to the United States too late in the year to meet the substantial presence test may also elect to be a resident for part of that year, if he/she meets certain conditions in IRC 7701(b) and is present in the U.S. for at least 31 days in the year, and continues U.S. residence in the following year.

Under certain circumstances, this election can be beneficial, and calculations contemplating the effect of the election should be made in the preparation of the dual status tax return to determine the optimal treatment. Persons making this election cannot claim any benefit under any foreign tax Treaty which the U.S. is party to.

1.05 U.S. Taxation of Residents and Non Residents

Due to the wide range of alternatives available to Canadian residents who conduct business in the U.S., this discussion has been restricted to the provision of personal services by Canadians in the U.S. only.

Non-residents who are taxable in the U.S. on their U.S. source income must file form 1040 NR by June 15 each year for the prior calendar year. Married residents of Canada may claim exemptions for a spouse and dependent children who lived with them. Although the maximum tax rate used on the form 1040 NR is the same as that for form 1040, fewer deductions and exemptions are generally available, resulting in a higher overall federal tax cost. Non residents filing form 1040 NR cannot claim the standard deduction, but must itemize deductions.

(a) Canadians Employed in the U.S.

A resident of Canada who is employed by a Canadian company in the U.S falls under the Canada U.S. Income Tax Convention (Treaty) - Article XV - "Dependent Personal Services", which states:

"Subject to the provisions of Articles XVIII (Pensions and Annuities) and XIX (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State."

This has been defined to mean that employment income is exempt from U.S. taxation and withholding unless it is over \$10,000 per year. If it is over \$10,000 per year, it is exempt only if:

- The individual was in the U.S. less than 183 days in any 12 month period, and
- The cost of salary is not borne by (deductible by) a U.S. resident employer or an employer with a fixed base in the U.S.

Therefore, to be exempt under the Treaty, an individual must be employed in the U.S. by a Canadian corporation without a fixed base in the U.S. Employment in the U.S. by U.S. employers, and Canadian employers with a permanent establishment or fixed base in the U.S. is fully taxable in the U.S.

A Canadian employer with a fixed base in the U.S. who hires or transfers Canadian residents to work in the U.S. should ensure that U.S. withholding taxes are deducted and remitted to the U.S., and that withholdings to Revenue Canada are eliminated, except for those required to fund Canada Pension Plan (under the Totalization Agreement). Failure to do so can create a cash flow problem for the employee, since they will be taxable in the U.S. and will have to pay U.S. taxes before the Canadian withholdings are recovered through the operation of the foreign tax credit.

Although persons employed by U.S. resident employers and foreign employers with a U.S. fixed base are subject to tax withholding at source on U.S. source income, and are liable to file form 1040 NR to disclose that income, the overall tax cost to the individual will not necessarily

be increased as a result of the operation of the foreign tax credit available in Canada for the taxes paid to the U.S. or a state.

A person who is exempt from U.S. taxation under the Treaty must still file:

U.S. 1040 NR Nonresident Alien Individual tax

return - this return would not include any income, but would be filed to preserve the Treaty based exemption from taxation.

Form 8833 - Disclosure of Treaty Based Position

- disclosing the basis for exclusion of income. Law requires this, with severe penalties for failure to disclose a Treaty based position.

Form 8840 - Closer Connection Exemption - to prevent taxation of world income in the United States by virtue of presence in the U.S. - through the establishment of a closer connection to Canada;

U.S. Form 8233 Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual -

to prevent withholding of income tax at source on employment income from U.S. sources.

Canadian T-1 Individual Income Tax Return - including world income and the employment income earned in the United States;

Failure to file may result in a fine, and potential denial of the Treaty exemption.

Persons who fail to file the Treaty based disclosure returns on the presumption that they are not taxable in the U.S. also risk having tax assessed in the U.S. at a later date when the Canadian return is barred from adjustment as a result of the time statute to include the additional tax under the foreign tax credit provisions in Canada - thus resulting in potential double taxation. It is therefore extremely important to comply with the letter of the law when it applies to the filing of tax returns, even if there is no apparent immediate tax liability.

(b) Canadian Residents Providing Self Employed Personal Services in the U.S.

A Canadian resident providing personal services in the U.S. as a self-employed individual formerly fell under the Canada U.S. Income Tax Convention (Treaty) -- Article XIV - "Independent Personal Services", which has been eliminated effective January 1, 2010. Currently Treaty Article VII - "Business Profits" is invoked to tax a business only in the country of

residence unless it has a "permanent establishment" in the other country. According to the Fifth Protocol:

Permanent Establishment Defined:

The definition of "permanent establishment" was subject to much interpretation in the former Treaty. Under the new rules, the application of benefits in many cases is tied to whether a person or company has a permanent establishment in a contracting state. A permanent establishment is now created where an individual spends more than 183 days in the other state and during that time more than 50% of the gross revenue generated by the business is derived from services rendered in the other state by that individual. A permanent establishment may also be created where services are provided in the other state for more than 183 days in any 12 month period with respect to a project for a resident of the other state.

Proportional Taxation:

Consistent with changes in the definition of "permanent establishment" mentioned above, the blanket exemption from taxation available to individuals or businesses providing business services in the other state (but not through a permanent establishment) has been repealed. Now, "business profits" are taxable in each state on a basis proportional to the activity carried out through a permanent establishment in each state.

Assuming that the individual is not deemed to have a permanent establishment in the U.S. under the new definition, the following filings may be required each year:

U.S. 1040 NR Nonresident Alien Individual tax

return - this return would not include any income, but would be filed to preserve the Treaty based exemption from taxation.

Form 8833 - Disclosure of Treaty Based Position

- disclosing the basis for exclusion of income. Law requires this, with severe penalties for failure to disclose a Treaty based position.

Form 8840 - Closer Connection Exemption - to prevent taxation of world income in the United States by virtue of presence in the U.S. - through the establishment of a closer connection to Canada;

U.S. Form 8233 Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual -

to prevent withholding of income tax at source on self employment income from U.S. sources.

Canadian T-1 Individual Income Tax Return - including world income and the self

employment income earned in the United States;

Canadian form CPT56 - Application for **Certification of Coverage of Employment under the Canada Pension Plan Pursuant to Article V of the Agreement on Social Security between Canada and the United States.** - to prevent the requirement to deduct and pay social security taxes in the United States.

If, however, the individual does have a permanent establishment in the U.S. under the new definition, the following forms will be required each year:

U.S. 1040 NR Nonresident Alien Individual tax return - this return would include income and expenses associated with the U.S. permanent establishment.

Canadian T-1 Individual Income Tax Return - including world income and the self employment income earned in the United States;

Canadian form CPT56 - Application for Certification of Coverage of Employment under the Canada Pension Plan Pursuant to Article V of the Agreement on Social Security between Canada and the United States. - to prevent the requirement to deduct and pay social security taxes in the United States.

(c) Canadians Providing Personal Services in the U.S. as Independent Contractors Through Their Own Canadian Corporation

Canadian residents may use a Canadian corporation to derive income from personal services in the U.S. If the individual providing the services spends over 183 days in the U.S. in any 12 month period, they would be taxable on income earned while in the U.S., and should be on a U.S. payroll. Note that if an employee of a Canadian corporation who works in the U.S. anticipates that over 183 days will be spent in the U.S. in any 12 month period, U.S. payroll should be established from the first day of employment. The Canadian corporation would be proportionally taxable in the U.S. if it has a permanent establishment as defined in the Fifth Protocol to the Treaty.

If the individual has no other dealings in the U.S., the individual employed by his own corporation may fall under Treaty Article XV (Dependent Personal Services) if the time and income threshold amounts are met. Assuming the individual is not exempt under Treaty the following filings may be required each year:

Personal Filings:

U.S. 1040 Individual tax return (Including world income if factual or elected residence is established in the U.S; A separate state return is also required;□

Canadian T-1 Individual Income Tax Return- including world income and a foreign tax credit for taxes on the 1040;

Form 5471 Information Return of US Persons with Respect to Certain Foreign

Corporations: Any person who is or becomes a U.S. person by virtue of residence, who operates a foreign corporation, must disclose and include in income all passive and personal services income not derived from the country of incorporation – Subpart F. Income.

Any US person (including someone who becomes a US person during the year) must include in current taxable personal income on his 1040, his distributive share of Subpart F income earned by a foreign controlled corporation during the year on form 5471 whether distributed or not (subject to some deductions for qualifying deficits) pursuant to IRC Sec 951. Subpart F income includes income of the foreign corporation which relates to passive activities like rents, interest and dividends (unless part of active business), services rendered outside the foreign country, foreign personal holding company income, sales commissions earned for sales outside of the foreign country.

This law includes personal service income of US persons, which has been channeled through a foreign country in their personal corporation. Therefore, a Canadian who goes to the US to work providing personal services in the US through a Canadian corporation he/she controls, and becomes a US person by virtue of residence, would be liable to include all net service income in his/her US return which is earned by the Canadian corporation, whether distributed or not. To further complicate matters under US rules (IRC267), Canadian style accruals of management bonuses are not permitted to cash basis related parties, and all “bonus” amounts must be paid within the tax year increasing the complexity of tax planning for corporations operating in the U.S.

Corporate Filings:

U.S. Form 1120-F U.S. Income Tax Return of a Foreign Corporation – The corporation would file details of income and expenses related to the U.S. component of operations on a “proportional” basis.

U.S. Form W-2 & W-3 – Wage & Tax Statement and Summary Remittances of tax should be made if the expected stay in the U.S. is over 183 days in the year or if more than \$10,000 is paid. Appropriate federal and state payroll tax withholdings should be made on a U.S. based payroll. (otherwise forms 1042 & 1042S are filed).

U.S. Form 5472 - Information Return for 25% Foreign Owned Corporation and Related Party Transactions - to disclose dealings with the Canadian shareholder.

Canadian T-2 Corporation Income Tax Return – Foreign tax credits may need to be applied at the corporate level if all U.S. source income is not disbursed as salary.

Canadian form CPT56 - Application for Certification of Coverage of Employment under the Canada Pension Plan Pursuant to Article V of the Agreement on Social Security between Canada and the United States. - to prevent the requirement to deduct and pay social security taxes in the United States.

Canadians who operate a small business corporation that would otherwise be eligible for the “Small Business Deduction” under Para. 125 of the Income Tax Act (Canada) should be cautioned that in order to be eligible for the low corporate rate of tax on Canadian Controlled Private Corporations, the corporation must be engaged in an active business carried on in Canada. Income from personal services rendered by the majority shareholder in the U.S. and paid to the corporation will not be eligible for the lower Canadian corporate rate of tax..

1.06 Foreign Corporation Treatment in the U.S.

(a) Deferred Foreign Income Corporations

If a Canadian spends sufficient time in the U.S. and meets the substantial presence test, the result may be that he/she becomes liable to reporting the operations and retained earnings of Canadian corporations. Under the transition to the participation exemption system of taxation earnings retained while the corporation is a “controlled foreign corporation” is subject to tax in the

U.S. This tax is applied to all earnings retained within the corporation since 1986.

In order to understand the implications of the new rules, it is important to define some terms used in the legislation:

A deferred foreign income corporation (DFIC) with respect to any U.S. shareholder is any "specified foreign corporation" of the U.S. shareholder that has accumulated post-1986 deferred foreign income as of November 2, 2017, or December 31, 2017, greater than zero (Code Sec. 965(d)(1), as amended by the 2017 Tax Cuts Act).

A specified foreign corporation is (1) a CFC, or (2) any foreign corporation in which a domestic corporation is a U.S. shareholder.

Therefore, insofar as an individual who becomes a U.S. person by residing in the U.S. and who has accumulated retained earnings in a controlled corporation (while a U.S. person), the transition tax appears to be applicable to the entire amount of earnings retained since 1986, even though these earnings were not considered subpart F income in all prior years because they were from active business income carried out in Canada.

The mechanism for the imposition of the transition tax is subpart F income. Therefore for the last tax year beginning before January 1, 2018 the subpart F income of a deferred foreign income corporation is increased by the accumulated post 1986 deferred foreign income (net of certain deficits) of the corporation as of either November 2, 2017, or December 31, 2017, without regard to the nature of the income accumulated.

(b) Global Intangible Low Taxed Income (GILTI)

A person who is a U.S. shareholder of any controlled foreign corporation (CFC) is required to include its global intangible low-taxed income (GILTI) in gross income for the tax year in a manner generally similar to that for Subpart F inclusions. The computation of GILTI is complex and requires the calculation of certain items of each CFC owned by U.S. shareholders, and then a single GILTI inclusion amount is determined by reference to all the U.S. shareholder's CFCs. The

provision applies to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders with which or within which such tax years of foreign corporations end.

The GILTI inclusion is treated similarly to a subpart F inclusion, for some purposes, but it is determined in a very different manner. In comparison to the computation of GILTI, subpart F income is determined at the level of the CFC and then included in the gross income of the U.S. shareholder according to the U.S. shareholder's pro rata share of the income. The computation of the U.S. shareholder's pro rata share of the CFC's subpart F income is generally the last step in the process. The amounts are taken into account on a CFC-by-CFC basis. Because the GILTI inclusion amount is determined on the basis of all of the U.S. shareholder's CFC, it ensures that the U.S. shareholder is taxed on GILTI, wherever it is derived.

Canadians who spend significant time in the U.S. must be aware of these new rules to prevent the imposition of these new taxes on Canadian corporation activities.

1.07 U.S. Flow Through Entities Owned by Residents of Canada

In the United States certain business entities such as Limited Liability Companies (LLC) or subchapter S corporations are "flow through" entities, where the entity does not pay tax, but where the net income and other tax results flow through to the members or shareholders on a pro rata basis. Due to the ease of establishment and simplified operation, entities like the LLC are the choice of many U.S. practitioners.

(a) Effect of Direct Ownership of Flow Through Entities

Canadian residents doing business in the United States should only consider direct ownership of a flow through entity once they have become non residents of Canada. Because Canada does not recognize the flow through nature of these entities and considers them to be corporations the income effect on Canadian residents is complicated, since a foreign tax credit is not fully available for taxes paid in the U.S. This is primarily because the U.S. taxes the allocated income (from form K-1) from a flow through entity, whereas that allocated income is not taxable in Canada (since it is the income

of a corporation.) When a distribution is taken from a flow through entity, it is not taxable in the U.S., since it represents the distribution of otherwise taxable profit allocations, but in Canada a distribution is considered to be a dividend from a corporation. Since tax was never paid in the U.S. on the distribution, and since the flow through entity is not itself taxable, foreign tax credits, if available at all, would be limited to the maximum credit available for dividends (15%). This results in an element of double taxation.

(b) New Rule Affecting Single Member LLC's

A single member LLC is considered a "disregarded entity" for U.S. tax purposes, and accordingly its operations are reported on the member's individual tax return. Where a single member LLC is owned by a non U.S. person or entity, new regulation 301.7701-2(c)(2)(vi)(A) classifies these entities as corporations. This triggers Internal Revenue Code section 6038A under which, effective for tax years ending after 2016) form 5472 must be filed timely each year to report transactions with foreign owners, even if a tax return is not required. Failure to file form 5472 can result in a penalty of \$10,000 per occurrence.

1.08 Consequences of Moving

(a) Leaving the United States

Non U.S. citizens leaving the U.S. during a year and wishing to report their anticipated annual income during the year may file form 1040-C - U.S. Departing Alien Income Tax Return. The 1040-C is not a final return, and a 1040 or 1040NR must still be filed within the required time limits. A non U.S. citizen who leaves the United States will normally have a dual status tax year in the year of departure.

(b) Leaving Canada – Canadian Taxation of Non Residents

Persons who are not residents of Canada are taxable in Canada on income from Canadian sources.

(c) Consequences of Leaving Canada

Canadians who give up residence in the year are deemed to have disposed of all of their capital properties at fair market value at the time of departure from Canada, giving rise to deemed capital gains or losses that are reportable in the year of departure.

“Taxable Canadian Property” such as Canadian real estate or shares of non-listed corporations, resource property, and trusts is not deemed to be disposed of on departure, but is subject to non resident withholding tax, and filing requirements upon eventual disposition.

Deemed dispositions of capital property which are not actually disposed of while absent from Canada, may be reversed if the individual returns to Canada as a resident within five years of departure.

Individuals permanently moving to the U.S. should consider disposing of capital property prior to establishing U.S. residence, since unlike Canadian rules, the U.S. will impose a tax on any capital gain based on original cost, from a disposition of capital property by a resident. No provision is made for revaluing the capital property at the time of entry to the U.S., unlike under Canadian capital gains rules.

1.09 Rental Real Estate in Canada

A non-resident of Canada who receives Canadian rental income may file a Sec. 216 return (within two years of each year end) to report the rental property under Part I, rather than being taxed under Part XIII (withholding taxes - non residents). Form NR6 is used to undertake to file a Sec. 216 return and to reduce withholding requirements to actual expected profits (rather than gross rents). Even though no personal exemptions may be claimed on such a tax return, an RRSP deduction may be made to the extent a contribution is made within available room. The effect of Para 216 on net income is usually beneficial.

(a) Registered Retirement Savings Plans and Pension Income

No rollovers of Canadian RRSP's are feasible to U.S. IRA's or similar plans (or visa versa), since such a transfer would be considered a distribution under Canadian law. Accordingly, persons moving to the U.S. after a work period in Canada should consider leaving the RRSP intact, and drawing funds from the plan only upon retirement or as provided for under Canadian law.

Upon withdrawal by non-residents, RRSP funds will be subject to a 25% non-resident withholding tax and other forms of pension from Canadian sources may be subject to other Treaty based withholding rates. A non-resident may recover a portion of nonresident withholding tax by electing to file a return under Sec. 217, which taxes

RRSP and certain other pension income but considers world income in the calculation. A Sec. 217 return must be filed by June 30 of the following year, or it will not be accepted by CRA.

For U.S. tax purposes, RRSP withdrawals are taxable as pension income, and eligible for a foreign tax credit for non resident withholding taxes imposed by Canada. Income earned within an RRSP is not subject to U.S. tax unless withdrawn. In the state of California, however, income earned within an RRSP is taxed for state purposes annually, and as a result RRSP withdrawals consisting of contributions prior to entry to California, and income reported in California are not taxable at the state level.

Other Income

Part XIII of the Income Tax (Canada) imposes a withholding tax on various forms of income from Canadian sources earned by non-residents

(b) Roth IRA's in Canada

Under provisions of the Fifth Protocol to the Convention, a Roth IRA is considered a “pension” for the purposes of Article XVIII(3)(b) as long as no contributions are made to the plan while a resident of Canada after December 31, 2008.

To ensure that income earned within a Roth IRA is deferred and considered a “pension” under Article XVIII of the Convention, an election must be made by April 30 after the year a person becomes or is considered a resident of Canada. Income earned after the date of a “Canadian Contribution”, based on the contributions made while a resident of Canada will be considered taxable in Canada in the year earned. There is no provision for a late filed Roth election.

1.10 U.S. Vs Canadian Estate Taxation

The U.S. and Canada have considerably different systems of taxation related to the estates of deceased persons.

(a) Estates in Canada

For Canadian purposes, a Canadian resident, is deemed to have disposed of all property owned at the date of death at fair market value, thus triggering capital gains tax on any unrealized capital gains. Tax deferred items, such as RRSP's are deemed to be disposed of at the

same time, subject to certain rollovers available to the spouse of the deceased. The executor is permitted to file up to four separate income tax returns for the same decedent for the year of death for four separate classifications of income. The beneficiaries of the estate receive the property with a tax value equal to the fair market value used by the estate on the deemed disposition, and there is no system of estate taxation.

(b) U.S. Estate Taxation of Residents and Citizens

The U.S. federal estate and gift tax continues to apply to U.S. citizens and U.S. domiciliaries, but only when the value of the taxable estate (plus adjusted taxable gifts) exceeds a generous basic exclusion amount.

Estate tax is imposed on the taxable estate at graduated rates up to a top marginal rate of 40%. A unified federal estate and gift tax exemption (the basic exclusion amount) applies to cumulative lifetime taxable gifts and transfers at death. Transfers between U.S. citizen spouses generally qualify for an unlimited marital deduction.

Gift tax is levied on persons who transfer portions of their property during their lifetime for less than full consideration. Although tax is rarely payable currently because of the unified exemption, taxable gifts reduce the remaining estate and gift tax exemption available at death. For 2025, there is an annual exclusion of \$19,000 per donee for gifts of a present interest; gifts within this annual exclusion generally do not use any of the lifetime exemption.

For 2025, each citizen or resident taxpayer is allowed a unified estate and gift tax exemption of approximately US\$13.99 million, effectively sheltering up to about US\$27.98 million from transfer tax for a married couple with proper planning. Amounts in excess of the remaining exemption are subject to federal estate or gift tax at rates up to 40%.

The estate tax system is designed to defer the major tax cost until the second of a married couple die, since transfers to a U.S. spouse are exempt from estate taxation (by the application of the marital credit). Qualified trusts are also used to plan an orderly taxation of estates. Severe complications may result in cases where a U.S. citizen is married to a non resident alien, since the U.S. citizen's estate may be increased by a bequest from a non resident alien spouse. Specialized planning including the use of trusts is recommended in such cases.

The exemption against estate tax is reduced by taxable lifetime gifts (since 1932) exceeding the annual gift limit, (which is \$15,000 for 2019) thus reducing the opportunity for distributing an estate during the lifetime of the decedent.

The beneficiary of an estate receives property at the fair market value used in the estate valuation, notwithstanding that no capital gains tax was paid by the estate on the value of the assets.

(c) U.S. Estate Taxation of Nonresident Aliens

Under current U.S. law, a nonresident alien is generally subject to U.S. estate tax only on U.S.-situs property (for example, U.S. real estate and many U.S. securities). A fixed US\$60,000 exemption applies under the Internal Revenue Code. Above this level, graduated estate tax rates up to 40% can apply.

However, Article XXIX B of the Canada–U.S. Tax Treaty substantially improves this result for individuals domiciled in Canada who are not U.S. citizens. In general terms, the Treaty allows a prorated share of the same unified credit and, in some cases, a marital credit that is available to U.S. residents. As a result, many Canadian-resident decedents with U.S.-situs assets will pay little or no U.S. estate tax provided that the total worldwide estate is within the U.S. basic exclusion amount and the required U.S. estate tax return is filed on a timely basis.

(d) Canadian Marital Credit

Paragraph 3 of Article XXIX B of the Treaty allows a special marital credit for transfers of property to a surviving spouse who is not a U.S. citizen, but a citizen of or resident of Canada. To limit the provisions of this article to smaller estates, if certain conditions are met, this Treaty article allows for a marital deduction limited to the lesser of either the tax which would otherwise be payable on assets transferred to the spouse, or the amount of credits otherwise available. In order to invoke this special “Canadian Marital Credit”, the trustee must waive the benefits of any marital deduction which would normally be available under U.S. law.

(e) Foreign Tax Credits for Estates

Since the basis of taxation of estates is different in Canada and the United States, no foreign tax credit is permitted. However, Canadian capital gains taxes resulting from deemed dispositions on death are deductible from the gross estate for U.S. purposes.

This summary has been designed to provide a concise overview of the subjects addressed, and may not be complete. Reference should be made to original legislation prior to acting on any matter, and professional advice should also be obtained.

Please contact us for a confidential review of your individual situation. To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any tax advice contained in the body of this document was not intended or written to be used, and cannot be used, by the recipient (a) for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions and (b) for the purpose of promoting, marketing, or recommending any tax-related matters addressed within to another party.



Mark T Serbinski, CA, CPA