Special points of interest:

- Specific Matters Relating to U.S. Non-Resident Aliens from Canada & Filing Requirements for U.S. Citizens
- Visa for The Treaty Investor—E-2 Status

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Cross-Border Tax Insight
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NORTH AMERICAN TAX SERVICES

Cross-Border Tax Insight

Cross-Border Tax Newsletter

Specific Matters Relating to U.S. Non-Resident Aliens from Canada & Filing Requirements for U.S. Citizens

Having recently spoken at two tax conferences, it dawned on me that most Canadian tax practitioners are not really interested in filing U.S. tax returns for U.S. citizens living in Canada, given the sheer complexity of such filings. They are, however, frequently required to advise their clients on the need to comply with such filing requirements.

Clients (specifically U.S. citizens living in Canada and Canadian residents with U.S. sources of income) will be very understanding and appreciative when your firm is able to assist them in understanding some of the U.S. tax compliance requirements applicable to their given tax situation. In addition, they may appreciate your firm's assistance in directing them to a suitable cross-border tax practitioner or firm in certain more complicated and challenging situations, specifically when your firm lacks expertise in such areas. Your clients will understand that your firm specializes in Canadian, and not U.S., taxation.

In certain situations, you may be tempted to retain the Canadian tax work, while delegating the U.S. tax work. Typically, there will be links between the Canadian and U.S. tax returns (consider foreign tax credits, treaty positions, timing of reported income, etc). Thus, in many instances, the returns may have to be prepared simultaneously. In any event, if you decide to complete the Canadian tax returns while delegating the American ones, you should be prepared to co-operate with the U.S. tax practitioner throughout the process.

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It is important to note that the U.S. tax preparer (in dealing with U.S. citizens living in Canada) will have to review and convert Canadian tax-related information into U.S. dollars in any case (recall that both countries tax worldwide income on the basis of residency and, in the case of the U.S., on the basis of citizenship). Accordingly, it may be more efficient to have him or her assume responsibility for preparing the Canadian tax return(s), in addition to any applicable U.S. tax return(s).

The following questions are often asked by tax practitioners and financial planners:

1. When are individuals (U.S. citizens and residents) required to file U.S. individual income tax returns (Form 1040)?

2. Under what circumstances will Canadians be required to file form 1040NR and how may the Canada-U.S. Tax Treaty affect such filings?

3. What about state tax filing requirements?

When are individuals (U.S. citizens and residents) required to file U.S. individual income tax returns (Form 1040)?

As mentioned in previous newsletters, U.S. citizens/residents must file a U.S. individual income tax return (Form 1040) to report their worldwide income to the taxing authorities, despite the fact that they may be living outside of the U.S. For such persons, income tax returns will be required only if a taxpayer's gross income exceeds a certain threshold specified in the Internal Revenue Code. The threshold in question, as applicable to a specific category of filer (single, married filing separately, married filing jointly, or head of household), is made up of the sum of a taxpayer's personal exemption and his or her standard deduction.

So in 2001, for example, a single person who is a U.S. citizen or resident would not be required to file, in the event that his or her gross income is less than $U.S. 7,450 (standard deduction of $4,550 + personal exemption of $2,900 = $7, 450).

Under what circumstances will Canadians be required to file form 1040NR and how may the Canada-U.S. Tax Treaty affect such filings?

Canadians (or other non-U.S. persons), despite the fact that they are not U.S. citizens or considered U.S. residents, may be taxed on certain U.S. sources of income earned or received during the course of a specific tax year. Such Canadians or other foreign (non-U.S. persons) are referred to as *non-resident aliens* in the Internal Revenue Code. In essence, non-resident aliens are neither U.S. citizens nor U.S. residents.

Three key categories will trigger taxation for the non-resident alien:

a) U.S. business or employment income (referred to as income effectively connected to a U.S. trade or business).

b) U.S. source investment income (not effectively connected to a U.S. trade or business).

c) Certain capital gains.

Assuming that any of such categories of income apply to a non-resident alien, a taxpayer would be required to pay tax in the U.S. on such income by filing a non-resident alien U.S. tax return (Form 1040NR).

With regards to income effectively connected to a U.S. business or trade or employment, graduated tax rates will apply. Such tax rates and tax brackets are the same as those that apply to U.S. citizens.

Note that rental income may also be treated as effectively connected to a U.S. business or trade, provided that an election is made by the taxpayer. The benefit of making such an election is that tax (using graduated U.S. tax rates and brackets) will be owing on the net income (i.e. income less related rental deductions). If such an election is not made, tax will be withheld and owing based on 30 per cent of the gross annual rental income of the non-resident alien. In sum, most non-resident alien taxpayers will find that their rental-related tax liabilities are much lower if such an election is made, rather than paying 30 per cent tax on the gross rental income.

Also with regards to capital gain taxation under the Canada-U.S. Tax Treaty, in general, capital gains with respect to U.S. personal property (other than property that is effectively connected income with a U.S. business or trade or property that is considered a U.S. real property interest) will be taxable only in the country of residence of the non-resident alien. Thus, if a Canadian (a U.S. non-residentalien) disposes of Microsoft shares, such gain will be taxable only in Canada.

Certain capital gains are taxable to non-resident aliens of the U.S. If such capital gains are taxable to the non-resident alien, graduated tax rates will ultimately apply to such gains, regardless of any tax withheld at source. Examples of such taxable capital gains, as alluded to above, would include property that is effectively connected to a U.S. trade or business or property that is considered a U.S. real property interest.

An interest in U.S. real property includes an interest in land, minerals, buildings and personal property associated with the use of real property. Such interests include both a direct ownership of real property in the U.S. and an interest in certain U.S. corporations, partnerships, estates and trusts that own real property interests.

The other relevant taxable category of income of Canadians who are considered U.S. non-resident aliens, is U.S. source investment income. In general, U.S. domestic law requires that 30 per cent of such amounts be withheld on such gross amounts paid . However, under the Canada-U.S. Tax Treaty, typically lower rates of withholding apply. Such amounts withheld under the Treaty will consist of the final U.S. tax liability on such sources of income for non-resident aliens. Specifically, Canadians (who are not U.S. citizens or U.S. resident aliens) will be required to have 10 and 15 per cent withheld from U.S. source interest and dividends paid or credited, respectively.

Of course, there are many other rules regarding non-resident aliens and the taxation of other sources of income such as alimony, student grants and scholarships, social security, pensions and annuities, but the above is just a starting point for those of you who typically are confronted with these types of issues in practice, or in your job. Be sure to get your clients to visit a cross-border tax professional or firm before they begin U.S. activity (investment-related or not).

What about state tax filing requirements?

Note that, despite the fact that certain income such as employment or self-employment income may be exempt under the Canada-U.S. Tax Treaty, the states are not signatory to such an accord.

Thus, the states will tax such income in many situations where employment or self-employment income is earned in a given state. Other states, for e.g. Tennessee, only tax state-sourced interest and dividend income. Thus, it is important that your clients also comply with applicable state tax legislation. Note that not all states tax personal income – examples of states that don't tax personal income are FL, WA, TX among others.

Capital gains relating to the disposition of U.S. real property interests will typically be taxable in the specific state in which the property is located, in addition to being taxed at the federal level.

The above are only highlights from a recent presentation. To receive a complete transcript in audio (in mp3 format) and/or written form (presentation slides saved as .pdf document) on this subject, please send me an e-mail (jsoussan@sympatico.ca) requesting such.

Please note that for interested firms and organizations, that would like my firm to provide your staff and management with a seminar or presentation on such related matters - there is still some availability in January and February 2002.

E-2 Status: Treaty Investor

In our last issue, we examined the Treaty Trader Option. While this is a highly successful option for existing companies with a high volume of trade with the U.S., it really does not apply to the individual who may wish to permanently establish in the U.S. and retain no interests in Canada.

The **Treaty Investor** Option is open to a wider range of business people. Rather than having to prove a qualifying history of dealing between Canada and the U.S., this visa focuses strictly on the amount of money ("Substantial Amount") to be invested in the U.S. This most frequently takes the form of start-up ventures, but is equally applicable to the entrepreneur who buys an existing business.

The U.S. enterprise must already be established or significant steps must already have been taken to establish it. If the business is not yet operational, a business plan with legal guarantees adequate to demonstrate a high likelihood of actualization will be necessary.

It logically follows that a new venture will involve more documentation than the simple purchase of an existing business as the latter will, presumably, already have full financials, articles of incorporation, etc.

The key issue is meeting the Substantial Amount requirement. Specifically, A Canadian investing entity or individual must have invested, or be actively in the process of investing, a **substantial amount of capital** in a U.S. concern.

Whether or not the investment amount meets the standard depends on the nature of the enterprise. For example, a manufacturing plant will require a greater investment than a small retail store. It is not required that the business, itself, be a multimillion-dollar operation. Rather, this issue is one of proportionality between the nature of the business and the size of the investment.

This is decided on a case-by-case basis. Thus, a detailed application package, usually prepared by an experienced immigration lawyer in consultation with the applicant's accountant and corporate lawyer, is highly advised.

There are some general guidelines, although many cases vary from the following illustration:

Minimum investment - $200,000* (however, I have processed successful applications with an investment one-half that size)

Total value of business or start-up cost	Minimum investment percentage
Less than $500,000*	75%
$500,000 - $3,000,000*	50%
More than $3,000,000	30%
Multimillion investment by large corp.	Any %

*all figures are in U.S. dollars.

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A few additional notes:

1. The investment funds may not be in the form of a loan guaranteed by the actual proposed business. The decision-makers will want to see that the applicant him/herself is on the hook personally.

2. The investment is more than marginal. It is expected that this will create positive net operating revenues, thus leading to job creation. This factor is most persuasive.

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The E-2 Treaty Investor Visa is particularly attractive because, whereas the E-1 Treaty Trader Visa requires continuous flow of funds from Canada to the U.S., the E-2 is a one-time investment.

These are complex applications to compile, but the processing time from the Immigration and Naturalization Service is reduced. It is clear that people wishing to bring money into the country, stimulate the economy and create jobs, are most welcome.

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We are wishing you a wonderful holiday season !

Joseph Soussan founded ***North American Tax Services*** in 1998. Since 1997, he is a member of the Certified General Accountants' Association of Ontario. He completed the CICA In-Depth Tax Course in 2000, and obtained CPA certification in 1998 from the state of Delaware. His firm is dedicated to providing both U.S. (primarily) and Canadian tax expertise (as applicable to international tax situations), tax-related educational services, and technical writing assistance to Canadian accounting and law firms. Joseph speaks frequently to organizations and companies on cross-border tax matters.

He currently practices exclusively in the areas of both cross-border corporate and personal taxation. He has, to date, provided extensive consulting and compliance services to the following firms in Toronto and Montreal: Deloitte and Touche, Ernst and Young, I.T.S.G, Cross-Border Tax Services, Horwath Orenstein LLP, and other local CA firms. If he can be of assistance to your firm, please do not hesitate to contact him (Tel: 416-567-1829).

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