An unnecessary overreaching of U.S. tax law into Canada

VERN KRISHNA | July 3, 2012 | Last Updated: Jul 24 3:59 PM ET
More from Vern Krishna

The Washington headquarters of the U.S. Internal Revenue Service. In 2014, Canadian banks will be required to report the income of American-Canadians to the IRS. Bloomberg News

Faced with ever-increasing sovereign debts and galloping deficits, governments are ramping up their tax-collection efforts to avoid the Greek malady of tax leakage. In the process, however, the United States is extending its territorial reach and making victims of nearly a million innocent Canadians with dual Canadian-American citizenship.

The United States is one of the few countries that taxes its citizens, regardless of where they live, on their worldwide income. The theory is that citizenship implies duties and responsibilities that require balancing the cost and benefits of national belonging.

Even non-resident citizens of a state are entitled to its political protection and, therefore, should bear some of the cost to reflect the benefits of citizenship. During the Israeli incursion into Lebanon in 2006, for example, Canadian, U.S., British and Scandinavian governments evacuated their citizens from the war zone. Canada evacuated 15,000 of its citizens from Lebanon at a cost of $85-million. Canadian taxpayers paid the bill.

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America uses a double-edged sword to curtail tax leakage. First, all U.S. citizens must file U.S. tax returns on their worldwide income, regardless of whether they owe any U.S. tax. The law defines “citizen” broadly to include any person born on U.S. soil.

Indeed, many foreign mothers travel to the United States just to have their babies born there so that the children may claim U.S.

citizenship in later life. On the flip side, there are “accidental citizens” — people who just happened to be born in the United States without any particular plan — for example, a woman giving premature birth while visiting the United States.

As a practical matter, the majority of American-Canadians have no actual tax liability for U.S. taxes because of threshold exemptions, foreign tax credits and Canada-U.S. tax-treaty provisions. Nevertheless, unlike Canada — which does not generally require an individual to file a tax return if she does not have any taxable income or tax payable — U.S. citizens must file U.S. tax returns by June 15 of each year.

Failure to do so exposes them to substantial sanctions and legal difficulties if they cross the border into the United States.

Many dual citizens living in Canada (some for more than 45 years) were either ignorant of the law or chose not to inquire too closely.

All was well when the Internal Revenue Service was docile and the economy booming. In light of the galloping U.S. deficit, however, the IRS has awakened and is hunting for tax dollars under every rock to finance its government’s profligate spending. Canadian-Americans are now in the IRS’s headlights.

Under U.S. law, a U.S. citizen travelling into or out of the United States must do so on a valid U.S. passport. A Canadian passport showing the United States as the individual’s place of birth is a sure giveaway that can attract attention.

The IRS will waive penalties for delinquent taxpayers who can show “reasonable cause” for their failure to file U.S. returns.

This is a vague provision that creates uncertainty and anxiety for many Canadians. If they do not file returns, they are subject to harsh penalties. If they do file returns and plead “reasonable cause,” they may get relief, but will never know until it is done.

Following representations from the Minister of Finance, Jim Flaherty, on behalf of the Canadian government, the Internal Revenue Service has announced that it will also waive penalties if low “compliance risk” delinquent taxpayers file their returns for the past three years and owe less than $1,500 — a form of partial amnesty. Going forward, these taxpayers will have to file U.S. returns.

High compliance-risk taxpayers remain exposed to severe penalties. The IRS has an open-ended offshore voluntary-disclosure program, which it may end at any time.

The program offers people with undisclosed income from offshore accounts another opportunity to get current with their tax returns. The current program has a higher penalty rate than the previous program.

The second blade of the sword is the recently enacted Foreign Account Tax Compliance Act (FATCA), which, commencing in 2014, will require foreign banks to report on the income of U.S. citizens living outside the United States.

Failure to do so will expose financial institutions to adverse withholding tax and other economic consequences. Understandably, Canadian banks are not enthused about such reporting requirements, which will be costly to implement and create stress with their customers.

FATCA penalties for wilful failure to report foreign financial accounts are draconian and can go as high as 50% of the highest value of the account in each year. Thus, two years of non-reporting can empty a bank account.

Dual citizens who are sufficiently disgusted by the oppressive tax rules may be tempted to renounce their U.S. citizenship and put an end to the tyranny of U.S. tax-reporting requirements. Before doing so, however, they should consider the long-term consequences.

Renouncing U.S. citizenship requires governmental approval, which usually involves an exit interview with a U.S. official who will question you about your motives for giving up your application. The United States can bar former citizens from re-entry into the country without a visa and, under a new proposed amendment, may bar entry to any individual who renounced her citizenship for tax reasons.

Giving up citizenship also triggers an exit tax — the citizen is treated as if he sold all of his property the day before renunciation.

In most cases, tax treaties prevent any double taxation. However, the renouncing citizen is also required to certify that she has been tax compliant for the past five years. This is awkward for those who have not in fact filed any U.S. tax returns.

Also of concern to wealthier Canadians, the U.S. will tax beneficiaries of an estate of a departed citizen at a rate equivalent to the U.S. estate tax.

The FACTA provisions are an unnecessary overreaching of U.S. tax law into Canada. The existing information-exchange provisions in the Canada-U.S. Tax Treaty should be sufficient and, if not, could be strengthened to permit government-to-government reciprocal reporting.

Mr. Flaherty is to be commended for seeking an early resolution of FACTA issues with his counterparts in Washington and for negotiating the partial amnesty for the innocent victims of U.S. tax-reporting rules so that law-abiding dual-citizen Canadians can cross the border without apprehension.