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Vern Krishna: Hard to slip long arm of Uncle Sam



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Department of Homeland Security

The Americans are coming, the Americans are coming!

As we saw in the American-Swiss tax disclosure war earlier this year, the Swiss eventually surrendered and changed their domestic law to allow banks to make disclosures to the United States. Sometimes it pays not to be an American, particularly when it comes to tax law.

Canada taxes its residents on their worldwide income and non-residents only on their Canadian source income. In addition to residence and source of income, however, the United States also taxes its citizens, regardless of where they live. Thus, American-Canadians with dual citizenship are subject to U.S. taxing jurisdiction.

The theory is that the citizens of a country should pay it taxes, regardless of where they reside, because they derive benefits from their political affiliation. During the Israeli incursion into Lebanon in 2006, for example, Canadian, American, 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. Approximately 7,000 of the evacuees promptly returned to Lebanon after hostilities ceased. Canadian taxpayers paid the bill.

There are approximately one million American citizens living in Canada who must file U.S. tax returns annually even if they do not owe any U.S. taxes. Thus, an American citizen living permanently in Canada might be taxable in both countries – in Canada based on residence and in the United States based on citizenship. He or she would then be potentially subject to double taxation of the same income.

We eliminate double-tax problems either through unilateral exemptions or through tax treaties. In the above example, under the Canada-U.S. Treaty, the American citizen would be taxable in Canada and would not generally be taxable in the United States, except for U.S. source investment income.

Apparently, many Americans living in Canada (some for more than 30 years) were ignorant of the law or chose not to inquire too closely. All was well when the Internal Revenue Service was docile. In light of the galloping American deficit, however, the IRS is hunting for tax dollars from undisclosed foreign accounts. Failure to file returns will subject Canadian/Americans to substantial sanctions and, in the extreme case, legal difficulties if they cross the border into the United States.

Second, and of even greater concern, the United States is insisting in its Foreign Account Tax Compliance Act (FATCA) that Canadian banks collect and report financial information on their American customers to the IRS. The FATCA rule, which is supposed to come into effect in 2014 for American-Canadians, has thrown a cat among the pigeons. The Minister of Finance, Jim Flaherty, published letters in several U.S. newspapers objecting to the extraterritorial reach of American law and its impact on the privacy of Canadians. Domestic banks have intensified their lobbying efforts to fight the American invasion of Canada.

The privacy argument is a red herring. Canadian banks must report investment income to the Canada Revenue Agency (CRA) annually, regardless of the account holders' citizenship. The offensive notion is the extra-territorial reach of the American government.

The Minister rightly points out that Canada has bilateral tax treaties and tax exchange agreements with the United States and that they should adequately protect the financial interests of the IRS. From the American perspective, however, the difficulty with tax agreements is that they are cumbersome and do not permit "fishing expeditions" for undisclosed income. Hence, it is difficult for the IRS to invoke a treaty without specific information about a specific person and his or her tax under-reporting.

As a matter of efficient tax administration, the IRS wants to recruit Canadian banks as their agents to better monitor American tax leakage. By shifting the onus of reporting to Canadian banks, FATCA will, in effect, circumvent the antifishing expedition rule and make income reporting routine. To be sure, going forward, potential Canadian targets could relinquish their U.S. citizenship. To do so, however, is not easy. There are additional tax-filing requirements and an exit tax.

In the American-Swiss tax disclosure war, Union Bank of Switzerland paid a fine of US\$780-million and disclosed about 4,500 names to the IRS. To date, the CRA has said it will not enforce the rules, as the Canada-U.S. treaty does not cover FATCA. Thus, American/Canadians who are willing to become tax refugees may choose to ignore the rules and pray that they are not caught in the tax net. However, those with U.S. properties are at greater risk.

Sometimes, economic power can trump territorial constraints in a tax war.