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TAX MATTERS

Tax tips – and traps – for Americans living in Canada

SPECIAL TO THE GLOBE AND MAIL

PUBLISHED JULY 1, 2026

I have a good friend who's an American living in Canada. Ironically, he's a chiropractor and the Internal Revenue Service in the U.S. is after him for back taxes. Go figure. He understands that, as a U.S. citizen, he has to file taxes south of the border each year. We had a chat last week about a bunch of tax tips and traps that Americans in Canada need to be aware of. Here's a list.

Foreign corporations

If you're an American who owns shares of a Canadian corporation, watch out for the U.S. Controlled Foreign Corporation (CFC) and Passive Foreign Investment Company (PFIC) rules.

A corporation is a CFC if U.S. shareholders own or control more than 50 per cent of its votes or value. In that case, you may have to report certain undistributed income on your U.S. tax return. A corporation may instead be a PFIC if more than 75 per cent of its income is passive, or at least 50 per cent of its assets produce passive income, such as interest, dividends, rents or capital gains.

Canadian holding companies and many mutual funds can be caught, triggering complex reporting and potentially punitive taxes. In some cases, having a non-U.S. spouse own these assets can help. These rules are highly technical, so speak to a cross-border tax pro for help.

RRSPs

Now for some good news. Registered retirement savings plans are generally tax-friendly for Americans living in Canada. Under the Canada-U.S. tax treaty, income earned inside an RRSP qualifies for automatic U.S. tax deferral, so you generally don't have to report annual investment growth on your U.S. return. If you own Canadian mutual funds, holding them inside an RRSP can also avoid many of the PFIC headaches that often arise when those same funds are held in a non-registered account.

TFSAs and RESPs

Tax-free savings accounts and registered education savings plans don't enjoy the same treatment. The U.S. doesn't recognize these as tax-sheltered plans, so income earned inside them are still taxable each year in the U.S. In the case

of an RESP, Canada Education Savings Grants are also taxable in the U.S.

In most cases, it's best to avoid having a TFSA if you're a U.S. citizen. As for RESPs, it may still make sense if you have a non-U.S. spouse or grandparent who can be the subscriber. If you're an American with these plans, you should file IRS Forms 3520 and 3520-A annually because these plans are generally considered foreign trusts.

Principal residence

Canada generally allows you to sell your principal residence free of tax if you can use the principal residence exemption. The U.S. provides an exemption only on the first US\$250,000 of gain, or US\$500,000 for married couples if you've lived in the place for at least two of the past five years. This means that Americans living here could face a sizable U.S. tax bill, even though Canada collects nothing. Before putting up the "for sale" sign, calculate the U.S. tax cost.

Corporate reorganizations

Many tax strategies that work in Canada don't produce the same result south of the border. Estate freezes, share exchanges and other corporate reorganizations may qualify for tax-deferred treatment in Canada while triggering immediate U.S. tax. Likewise, Canada's lifetime capital-gains exemption on qualifying private company shares has no equivalent in the United States. If you're contemplating a business reorganization, make sure the plan is reviewed from both sides of the border before signing any documents.

Life insurance

Life insurance deserves careful attention as well. Death benefits from a policy you own may be included in your taxable estate for U.S. estate tax purposes if you're an American citizen. Depending on your situation, ownership by a non-U.S. spouse or an irrevocable life insurance trust can solve the problem. As well, the rules governing tax-sheltered investment growth inside a life insurance policy differ between Canada and the United States, so confirm that any policy satisfies both countries' requirements.

Other considerations

There are a few other issues that are easy to overlook. Many Americans living in Canada must file an annual FinCEN Form 114 (FBAR) to report foreign financial accounts once certain thresholds are met. Higher-income taxpayers should also understand the potential impact of the Net Investment Income Tax, a tax paid to the U.S. on investment income that may not qualify for foreign tax credits.

Co-ordinating foreign tax credits between your Canadian and U.S. returns is important to avoid paying more tax than necessary. If you have significant wealth, U.S. gift- and estate-tax planning should be part of your long-term strategy, even if you've lived in Canada for decades.

Finally, if you've ever wondered whether giving up U.S. citizenship might simplify your life, don't make that decision without first understanding the expatriation, or exit tax, rules that can apply. Speak to a tax pro about these issues.

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