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Medical professionals and the interplay of the tuition credit and the foreign tax credit

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It is not uncommon for recently graduated medical professionals to take up employment in the United States immediately upon completion of their education and practical experience requirements. Those who maintained Canadian residence for tax purposes during the pursuit of their education have likely accumulated a significant tuition credit, given the time and financial commitment involved. The corresponding Canadian tuition/education tax credit is largely calculated by multiplying total tuition fees paid by the lowest federal (15%) and provincial marginal tax rates (5.05% in Ontario). The result of this calculation is used to reduce annual personal income taxes on a dollar-for-dollar basis.

Income sourcing and foreign tax credit

Generally speaking, when an individual performs employment services the related income is "sourced" to the country in which the physical services are performed. Consider, for example, a recently graduated general surgeon working at a hospital in the U.S. Her primary residence is in Canada and she commutes one day a week to the U.S. hospital where she earns approximately $75,000 USD annually. This income will be sourced to the U.S., meaning she is required to file a U.S. personal income tax return and remit U.S. personal tax on the income. As she is still a resident of Canada for tax purposes, she will also record this income on her Canadian income tax return (as Canada taxes resident individuals on worldwide income), though she will be permitted a foreign tax credit for any U.S. income taxes already paid. This simplified example demonstrates how the Canadian tax system works to avoid paying tax to two separate countries on the same income.

Tuition credit and foreign tax credit

To elaborate on the general surgeon example above, assume that she also accumulated a tuition carryforward amount of $100,000 during her post-secondary education. This amount typically may be used to offset personal income taxes of $20,500 in Ontario ($100,000 x 20.05%).

In this case, however, an issue arises on the Canadian side with the calculation of the foreign tax credit and the interplay between the tuition tax credit. It appears logical that, since U.S. personal taxes have actually been paid on the $75,000 USD of income, those taxes should first be used to reduce the Canadian tax burden. In fact, it is the tuition tax credit that must first be applied to offset any calculated Canadian personal income tax. If Canadian tax remains after the application of any tuition credits, only then may the foreign tax credit be applied. The end result can appear inequitable as no credit has been granted for foreign taxes paid and the tuition credit has been fully exhausted.

Now assume the individual also works at a Canadian-based hospital four to five days a week in addition to commuting one day to the U.S. On the advice of her Canadian accountant, upon graduating she immediately establishes an Ontario Professional Corporation through which all Canadian source income is earned. Annual income in the corporation amounts to approximately $500,000 CAD. A unique planning opportunity arises from the flexibility available in remunerating and establishing a compensation plan for the shareholder. Through proper planning and forecasting, it is possible to effectively reinstate the benefits of the available tuition tax credit while still benefitting from the U.S. taxes paid as a foreign tax credit.

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Given the significant post-secondary costs associated with pursuing a medical career, the benefits of the tuition tax credit should not be overlooked. For those who generate foreign source income, effective planning is critical to achieve maximum tax benefits. Contact your Collins Barrow tax advisor for more information.

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