When Bygones Aren't Bygones: Exploring Tax Solutions for U.S. Persons with Undeclared Canadian Retirement Plans and Accounts

By Hale E. Sheppard

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1. Introduction

Many Canadians migrate south each year and become U.S. residents or citizens. Along with the cold weather, they may also leave behind local retirement accounts, such as Canadian registered retirement savings plans (RRSPs) and Canadian registered retirement income funds (RRIFs). Preserving this Canadian nest egg is generally a good thing. Indeed, it is hard to find fault with financial planning for the golden years. This egg could turn a little rotten, though, if the person fails to appreciate the relevant U.S. tax obligations. Unfortunately, due to the disparate treatment of these Canadian retirement plans by the IRS and the Canadian Revenue Agency, coupled with the obscurity of various international tax requirements, many of our neighbors from the north lack the necessary appreciation. In other words, they are under the common, yet mistaken, belief that bygones are bygones, at least when it comes to their retirement plans back home. The potential consequences of this unawareness or misunderstanding include back taxes, penalties and interest of such magnitude that many new arrivals may curse their decision to relocate to the land of the free and the home of the brave.

The good news is that it is not too late to avert the problem. The bad new is that trying to resolve the situation in an improper manner could trigger even greater troubles. This article follows the evolving tax treatment of Canadian RRSPs and RRIFs, identifies the relevant U.S. tax requirements and the penalties for noncompliance, illustrates the problem by describing a typical scenario, and explores two major solutions, focusing on the pros and cons of each.

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2. Evolution of U.S. Treatment of Certain Canadian Retirement Plans and Accounts

The local tax treatment of Canadian RRSPs and RRIFs is similar to that afforded to individual retirement accounts (IRAs) and Code Sec. 401(k) retirement plans in the United States. To encourage people to save for retirement, certain contributions to and gains accumulated in these types of plans each year generally are not taxed. Taxation ordinarily does not begin until the beneficiary reaches a certain age and begins withdrawing funds from the plan. At this point, the person should theoretically have less annual income, which would place him in a lower tax bracket.[1]

Although beneficiaries of Canadian RRSPs and RRIFs enjoy tax-deferral benefits in Canada, they are not so lucky in the United States. Indeed, U.S. tax law dictates that an individual who is a U.S. citizen or resident, as well as a beneficiary of an RRSP or RRIF, is generally subject to current U.S. tax on income accrued in such plans, even though the income is not currently distributed to the individual. The harshness of this rule is mitigated by the United States-Canada Income Tax Convention ("Treaty"), which allows an individual to opt-out of this inconsistent tax treatment.[2] The current Treaty provides that an individual who is a U.S. citizen or resident and a beneficiary of a Canadian pension, retirement or employee-benefit plan that is exempt from Canadian income tax *may elect* to defer U.S. tax on the accrued yet undistributed income from the plan until such income is actually distributed.[3]

The current Treaty provides that an individual who is a U.S. citizen or resident and a beneficiary of a Canadian pension, retirement or employee-benefit plan that is exempt from Canadian income tax *may elect* to defer U.S. tax on the accrued yet undistributed income from the plan until such income is actually distributed.

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The IRS has issued a series of documents over the years to provide guidance on election measures, starting with Rev. Proc. 89-45, 1989-2 CB 596. In order to make the tax-deferral election under this initial revenue procedure, the beneficiary had to attach a written statement to his timely filed Form 1040 (*U.S. Individual Income Tax Return*) for the election year containing particular information.[4] For instance, the statement had to include the name of the trustee of the plan, the account number of the plan, the total amount of earnings from the plan during the year, the total amount of contributions to the plan during the year while the contributor was a Canadian resident and the balance of the plan at the end of the year. Rev. Proc. 89-45 further instructed the beneficiary to attach a similar statement to each of his subsequent Forms 1040, until the year in which a final distribution was made from the RRSP. The permanency of the election was clear; Rev. Proc. 89-45 expressly stated that an election, once made, could not be revoked without consent from the IRS.[5] Rev. Proc. 89-45 also clarified that each spouse who is a beneficiary of a Canadian RRSP or RRIF must file a separate tax-deferral election.[6] Thus, a couple filing a joint Form 1040 could potentially have to file two election statements with each return.

After more than a dozen years, Rev. Proc. 89-45 was superseded by Rev. Proc. 2002-23, 2002-1 CB 744. This IRS pronouncement was designed to accommodate the expansion of the Treaty by way of assorted protocols to cover not only RRSPs, but also RRIFs and other Canadian pension, retirement and employee-benefit plans.[7] Like its predecessor, Rev. Proc. 2002-23 described the procedure whereby a beneficiary of a Canadian RRSP or RRIF could elect to defer U.S. income tax on his share of the accrued income until that income is actually distributed to him. The election procedure itself was essentially unchanged; the beneficiary was obligated to file a written statement containing details about the Canadian plan(s) with his timely filed Form 1040 for the election year and all subsequent years.[8] Rev. Proc. 2002-23 did add one notable detail, though. It stated that an individual who is the beneficiary of more than one plan was required to make a separate election for each plan.[9]

The following year the IRS issued Notice 2003-25, IRB 2003-11, which confirmed additional requirements related to RRSPs and RRIFs. This latest IRS document began by explaining that there are certain information reporting requirements applicable to "foreign trusts."[10] These include filing a Form 3520

(*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) and/or Form 3520-A (*Annual Information Return of Foreign Trust with a U.S. Owner*), as necessary. If a person fails to file either of these information returns, then the IRS may assert significant penalties.[11] In Notice 2003-25, the IRS acknowledged that many beneficiaries and custodians of Canadian RRSPs and RRIFs were "unfamiliar" with the foreign trust reporting requirements. It is also likely that many were equally unfamiliar with the fact that these Canadian retirement plans and funds would be considered "trusts" for U.S. tax purposes. In light of the widespread unfamiliarity, the IRS decided to grant an automatic filing extension for tax year 2002 until August 15, 2003.

Apparently, few taxpayers filed their Forms 3520 or 3520-A by the extended deadline because the IRS issued its next release, Notice 2003-57, IRB 2003-31, a mere 10 days after such deadline. This newest IRS document contained "additional relief" with respect to the information reporting requirements for 2002. Notably, Notice 2003-57 provided that if the beneficiary of a Canadian plan made a proper election pursuant to Rev. Proc. 2002-23 and received no distributions from the plan during 2002, then the beneficiary was not obligated to file a Form 3530 or 3520-A for tax year 2002.[12] In other words, the IRS conceded that making the election, without more, would suffice for 2002 due to the pervasive ignorance of the foreign trust reporting requirements. For those who already filed incomplete Forms 3520 or 3520-A for 2002, the IRS agreed not to impose any penalties, provided that the beneficiary or plan supplied additional information upon request by the IRS.[13]

Four months later, the IRS changed its tune when it issued Notice 2003-75, IRB 2003-45. This document introduced a "new simplified reporting regime" developed by the IRS and effective beginning in 2003. Notice 2003-75 announced that the IRS was designing a new form to address Canadian retirement plans. Until the IRS completed this form, taxpayers were instructed to comply with various interim rules, which essentially required beneficiaries to make an election similar to the one first described by the IRS some 15 years earlier in Rev. Proc. 89-45.[14] One of the most interesting (and often overlooked) aspects of Notice 2003-75 is the IRS's dramatic change of heart regarding Forms 3520 and 3520-A. Earlier in the year, the IRS indicated in the Notice 2003-25 that Canadian RRSPs and RRIFs were "foreign trusts," and as such, U.S. beneficiaries had to file annual Forms 3520 and 3520-A. This position was seconded by the IRS shortly thereafter in Notice 2003-57. Now, in Notice 2003-75, the IRS reversed course entirely, stating that the "new simplified reporting regime" provided all of the information the IRS needs for tax-compliance purposes.[15] To formalize this change, the IRS invoked a tax provision authorizing the IRS to suspend or modify any filing requirements related to foreign trusts if it determines that the government does not have a significant tax interest in obtaining the information.[16] Although the IRS repealed the foreign trust reporting requirements with Notice 2003-75, it warned that beneficiaries of Canadian plans may still be subject to other requirements and penalties.[17]

Ultimately, the IRS issued Form 8891(*U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*). This form can be used by U.S. citizens and residents to report (1) contributions to an RRSP or RRIF, (2) undistributed earnings in an RRSP or RRIF, and (3) distributions received from an RRSP or RRIF. It can also be used to make a tax-deferral election pursuant to the Treaty, if such election has not been previously made. The Form 8891 must be completed and attached to the U.S. beneficiary's annual Form 1040. A separate Form 8891 is required for each applicable Canadian plan, and if both spouses have a reportable interest in a plan, then each spouse must file a separate Form 8891.[18]

3. U.S. Requirements and Potential Penalties

A. U.S. Tax Requirements

Several U.S. tax reporting and payment requirements could be triggered if a U.S. person fails to make a proper tax-deferral election. For instance, any income accrued yet not distributed by the Canadian RRSP or RRIF must be reported on his annual Form 1040, and he must pay taxes on such income. In addition, it is arguable that the taxpayer is required to file Forms 3520 and/or Forms 3520-A for all tax years before 2003. This is because the IRS did not rescind this filing requirement relating to foreign trusts until it issued Notice 2003-75, which applied only to tax years 2003 forward. Finally, regardless of whether the person files a tax-deferral election, he may be obligated to file an annual Form TD F 90-22.1 (*Report of Foreign Bank and Financial Accounts*), commonly known as the "FBAR" or foreign bank account report. If the U.S. beneficiary must file an FBAR, then he must

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make certain disclosures on his annual Form 1040, too. In particular, Part III (*Foreign Accounts and Trusts*) of Schedule B (*Interest and Ordinary Dividends*) of Form 1040 states the following:

> At any time during [the tax year at issue], did you have an interest in or signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? If yes, enter the name of the foreign country.

According to the FBAR instructions and applicable law, a person must file an FBAR if the following elements are met: (1) a U.S. person, (2) had a financial interest in, or signature authority over, or other authority over (3) one or more financial accounts (4) located in a foreign country, (5) and the aggregate value of such account(s) exceeded $10,000, (6) at any time during the calendar year.[19] These terms-of-art are tricky and subject to considerable debate within the international tax community. Examining them in detail goes beyond the scope of this article; however, it is important to take a brief look at whether a U.S. beneficiary of a Canadian plan has a reportable relationship.

For purposes of the FBAR, both direct and indirect interests qualify as "financial interests" in an account. A U.S. person has an *indirect* financial interest in an account if the owner of such account is one of several things, including a trust in which the person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.[20] Moreover, a person has "signature authority" over an account if he can control the disposition of the money or other property in the account by delivering a document containing his signature to the bank or other institution with which the account is maintained.[21] Stated differently, if a person is the primary beneficiary of a trust that owns an account or if the person can access the funds or other property in the account by presenting signed instructions, then that person generally has an interest that must be reported on an FBAR.

Based largely on the lack of IRS guidance on the issue, there is considerable ambiguity regarding who must file an FBAR.[22] However, many tax professionals believe that an FBAR is mandated for many foreign individual retirement accounts, pension accounts, and foreign trusts with foreign accounts.[23] This broad view finds support in the IRS instructions to Form 8891, which ominously state that "[y]ou may be required to file Form TD F 90-22.1."

B. Potential Penalties for Noncompliance

Failing to adhere to the tax filing and payment requirements described above can lead to severe penalties. For instance, not including the accrued income from a Canadian RRSP or RRIF on the annual Form 1040 could elicit accuracy-related penalties (such as negligence), as well penalties for late payments.[24] If the U.S. beneficiary neglected to file an annual Form 3520 or Form 3520-A, then he could face additional penalties, at least until 2003 when the IRS changed the law via Notice 2003-75.[25] Moreover, the beneficiary could face stringent penalties for not filing an annual FBAR reporting his interest in a Canadian RRSP or RRIF. Current law dictates that in cases of *non-willful* violations the IRS may impose a penalty of $10,000.[26] The penalty is dramatically higher, though, where there is willful disobedience. In such situations, the IRS may assert a penalty of $100,000, or 50 percent of the balance in the account at the time of the violation, whichever is greater.[27]

As if back-due taxes and penalties alone were insufficient, noncompliant taxpayers would also face significant interest charges on these amounts. An individual taxpayer generally must file his tax return by April 15 each year.[28] He must pay the tax due at this time, too.[29] If he fails to pay in full and on time, then interest begins to run on the underpayment amount.[30] To make matters worse, the interest is normally compounded daily.[31] Thus, the accumulation of interest, particularly in cases where the underpayment is large or the taxpayer is also facing penalties, can be a major concern.

Another concern for noncompliant taxpayers is the IRS's recent focus on Canadian RRSPs and RRIFs. The IRS announced last year that it, along with the Canada Revenue Agency, had make significant progress in halting an "abusive cross-border tax scheme" involving retirement plans.[32] This purported scheme involved the purchase of high-yield offshore investments through foreign entities or accounts using questionable withdrawals from Canadian RRSPs and other sources.[33] Although most beneficiaries of Canadian plans likely are not involved in these questionable actions, the attention of the Canadian and American tax authorities on the scofflaws may result in additional scrutiny to *all* retirement plans on both sides of the border.

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4. A Typical Scenario–How Do Taxpayers Find Themselves in This Predicament?

Now that we have seen what taxpayers are supposed to do and what could happen if they fail to comply, it is helpful to examine how these situations often arise.[34] The typical scenario involves a Canadian—let's call him Tom Taxpayer for the sake of simplicity—who decides to travel south, and then becomes a U.S. resident or citizen. Tom may be seeking warmer temperatures, a job opportunity, a change of pace, or something else entirely. The important thing is that, before departing, Tom opened and made contributions to a Canadian RRSP and RRIF. Tom is a skilled professional in his field, but he is a complete novice when it comes to taxes. He is not an accountant, professional tax return preparer, enrolled agent, certified financial planner, investment advisor or tax attorney. Moreover, other than the Canadian RRSP and RRIF, Tom has essentially no international experience or investments.

> In Notice 2003-25, the IRS acknowledged that many beneficiaries and custodians of Canadian RRSPs and RRIFs were "unfamiliar" with the foreign trust reporting requirements.

Tom was a complete foreigner to the U.S. tax system when he moved to the United States, but he fully intended to meet his tax and reporting obligations. Accordingly, he sought out a U.S. tax professional to prepare his annual Forms 1040 and to provide general tax advice. Tom was eventually introduced to an accountant—let's call him Ace Accountant—whom he believed to be adequately qualified. Tom retained Ace and then provided Ace with all of his tax-related documents each year, including those related to the Canadian RRSP and RRIF. Ace began preparing the returns in 1999, the year in which Tom first became a U.S. resident.

Ace had an accounting degree and regularly prepared Forms 1040 for dozens of clients, but he had very limited training for and experience with international tax issues. Therefore, despite his awareness of Tom's Canadian RRSP and RRIF, Ace did not make or advise Tom to make a tax-deferral election at the earliest possible moment (pursuant to Rev. Proc. 89-45). Moreover, Ace did report the accumulated income in these Canadian plans on Tom's Form 1040 each year because he incorrectly believed that such plans were treated like IRAs or Code Sec. 401(k) retirement plans. Since the income was not included in the Forms 1040, Tom did not pay current federal income tax on these amounts. Predictably, Ace also neglected to prepare information returns applicable to the Canadian plans, such as Forms 3520, Forms 3520-A and FBARs.

Years passed in this manner. Tom was never audited by the IRS; therefore, he had no knowledge that he was not in full compliance. One day in 2007, he was talking with some fellow expatriates, waxing nostalgic. During the course of their conversation, somebody mentioned his Canadian RRSP and all the dreaded U.S. tax requirements. A moment of sheer panic ensued. After catching his breath and allowing his heart rate to subside, Tom called Ace and conveyed what he has just heard about Canadian plans. Ace, equally panicked with the thought of a malpractice suit, immediately set to researching the issue. A few hours of study revealed that Ace had indeed committed several errors over the years, which he cautiously revealed to Tom. Outraged, Tom demanded that Ace immediately take all necessary steps to rectify the situation.

5. Examining Possible Solutions

There are two major schools of thought when it comes to assisting someone like Tom, each of which has certain advantages and disadvantages. These two approaches are described in detail below.

A. Begin Proper Filing and Reporting Upon Discovery of Requirements

Ace could decide to start doing things correctly for Tom going forward and simply hope that the IRS does not discover his previous transgressions. In other words, Ace could opt to file Forms 8891 making the tax-deferral elections in 2007, check the box on Part III of Schedule B of Form 1040 for 2007 indicating that Tom has an interest in foreign financial accounts, and file a timely FBAR for 2007 identifying the Canadian RRSP and RRIF.[35]

The obvious benefit of this approach is the reduced cost. Specifically, there would be no professional fees to examine all the tax and financial data for

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previous years, review the Treaty and related IRS pronouncements, prepare amended income tax returns and delinquent information returns for several years, *etc.*

This most glaring disadvantage with this tactic is that it leaves Tom highly exposed and vulnerable to intense scrutiny by the IRS. The IRS generally has three years from the time a tax return is filed to assess additional tax on such return.[36] There are several exceptions to this general rule that could apply in Tom's case. First, the assessment period is extended indefinitely if a taxpayer files a false or fraudulent return with intent to evade tax.[37] It is important to note that this exception applies regardless of whether it was the person who prepared the return, and not the taxpayer himself, who intended to dupe the IRS.[38] Second, if a taxpayer fails to file a timely Form 3520 or Form 3520-A, then the assessment period stays open until three years after the taxpayer ultimately files these forms with the IRS.[39] The IRS declared in Notice 2003-75 that Forms 3520 and 3520-A were not required for Canadian RRSPs and RRIFs, but this announcement only applies to year 2003 forward. The IRS could argue theoretically argue, therefore, that such forms were due in Tom's case from 1999 (the year he became a U.S. resident) through 2002 (the last year that the forms were required). Finally, the law provides that the statute of limitations regarding FBARs is six years from the time of the violation.[40] Assuming an FBAR is required for the Canadian plans, the IRS could assert penalties for 2001 through 2006.

In summary, if Tom were to allow Ace to follow the approach described above, he could face significant back taxes, penalties and interest with respect to many, many years.

B. Request a Private Letter Ruling

The better approach is to have Ace submit a private letter ruling (LTR) request to the IRS on Tom's behalf. This LTR request would ask for an extension under Reg. §301.9100-3 to make an election pursuant to Rev. Proc. 89-45 for 1999 through 2006 to defer U.S. tax on any income from Tom's Canadian RRSP or RRIF that was accrued but not distributed to him during each of these years. Alternatively, if the IRS is unwilling to grant an extension for some of the earlier years because the normal three-year assessment periods have already expired, then the LTR could seek an extension to make the tax-deferral election under Rev. Proc. 2002-23 for the open years, *i.e.*, 2004, 2005 and 2006. In all events, Ace would request that the LTR be drafted broadly enough to allow Tom to file on a penalty-free basis all applicable tax and information returns, including Forms 1040X (*Amended U.S. Individual Income Tax Returns*), Forms 3520 or 3520-A, and/or FBARs.[41]

The primary disadvantage to going this route is the cost. It all takes money—drafting the lengthy Private Letter Ruling (LTR) request and following its intricate procedural requirements, paying the application or "user" fee to the IRS, and preparing all of the necessary amended and delinquent tax and information returns.[42]

The advantages of this approach far outweigh the initial economic downside. If the IRS grants the requested LTR, Tom will essentially have the opportunity to go back to the beginning and make it all right. Doing so would allow him to avoid liability for back taxes, penalties and interest, which could be enormous depending on the number of years and violations involved. More importantly, perhaps, Tom will have peace of mind that an IRS auditor is not perpetually poised at the threshold ready to inspect his (erroneous) treatment of the Canadian RRSP and RRIF. Another positive aspect of seeking a LTR is that, based on its behavior to date, the IRS may actually be inclined to grant it. Tom's scenario is far from unique. In fact, his dilemma was extrapolated from numerous LTRs that the IRS has previously granted on this issue. One of the many reasons for the IRS's historical willingness to grant LTRs to taxpayers like Tom may be the fact that their cases tend to fall neatly within the parameters of Reg. §301.9100-3, as demonstrated below.

i. Overview of 9100 Extension Requests. The IRS has discretion to grant reasonable extensions of time to make certain "regulatory" elections.[43] In this context, the term "regulatory" elections means an election whose due date is set in one of several places, including revenue procedures.[44] The IRS will grant extension requests when the taxpayer provides evidence to establish that he acted reasonably and in good faith, and that granting him the extension will not prejudice the (economic) interests of the IRS.[45]

With respect to the first factor, a taxpayer generally is deemed to have acted reasonably and in good faith if, among other things, (1) the taxpayer requests an extension before the IRS discovers that he failed to make the election, (2) the taxpayer did not make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience, as well as the complexity of the tax return

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or issue), the taxpayer was unaware of the need to make the election, or (3) the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make, or advise the taxpayer to make, the election.[46]

Notwithstanding the general rules described above, a taxpayer will be deemed *not* to have acted in reasonably and in good faith if (1) the taxpayer is attempting to change a position on his tax return for which the IRS already has or could impose an accuracy-related penalty, (2) the taxpayer was informed in all material respects of the required election (including the tax consequences thereof), but chose not to file the election, or (3) the taxpayer is using "hindsight" in requesting the extension.[47] For these purposes, "hindsight" generally exists if specific facts have changed since the original deadline for making the election that now make the election advantageous to the taxpayer.[48]

With respect to the second element, the IRS uses two standards in determining whether its interests would be prejudiced by granting the extension. First, the interests of the IRS are prejudiced if granting the extension request would result in a taxpayer (or taxpayers, if multiple taxpayers are affected by the election) having a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer(s) would have had if they had made the election on time, taking into account the time value of money.[49] In other words, if the IRS would receive less overall tax money if it were to grant the taxpayer an extension, then its (economic) interests would be considered prejudiced. Second, the IRS's interests are ordinarily prejudiced if the year in which the election should have been made, or any taxable years that would have been affected by the election if the taxpayer had made it on time, are closed because of the general three-year assessment period before the taxpayer receives a ruling from the IRS granting the extension.[50] This factor serves to ensure that what's good for the goose is good for the gander. If the IRS is precluded from assessing tax, penalties and interest against a taxpayer because the assessment period for a particular year has already expired, then the taxpayer cannot go back to that year and take unfair advantage.

ii. Application of the Law to Tom's Case. The due date for making the tax-deferral election under the Treaty is found in Rev. Proc. 89-45 and later in Rev. Proc. 2002-23; therefore, it is a "regulatory" election. The IRS will grant extension requests to make regulatory elections when the taxpayer demonstrates that he acted reasonably and in good faith, and that granting him the extension will not prejudice the interests of the IRS.[51] A taxpayer generally is deemed to have acted reasonably and in good faith if any one of five factors is met. In Tom's case, three of these factors are satisfied. First, Tom is requesting an extension to make the election with respect to his Canadian plans before the IRS discovered his failure to make the election. Second, Tom failed to make the election because, after exercising reasonable diligence, he was completely unaware of the tax-deferral election or the need to make it. Tom is not an accountant, professional tax return preparer, enrolled agent, certified financial planner, investment advisor or tax attorney. Cognizant of his limited knowledge, Tom exercised reasonable diligence by hiring Ace, a qualified tax professional, and providing him with all of the relevant tax-related information and documents. Third, Tom reasonably relied on Ace. Despite the fact that Tom provided him with all of the information related to the Canadian RRSP or RRIF, Ace failed to make or advise Tom to make the tax-deferral election available in the Treaty.

Notwithstanding the preceding, the rules provide that Tom will be deemed not to have acted in reasonably and in good faith if any one of three factors is met. Here, none of these factors is present. First, Tom was *not* informed in all material respects of the election under Rev. Proc. 89-45 and Rev. Proc. 200-23, and simply opted not to make the election. In fact, he knew absolutely nothing about this election until 2007. Second, Tom is not using hindsight in requesting an extension. No specific facts have changed since 1999 (*i.e.*, the year during which he first became a U.S. resident) that make the election more advantageous to him now. Finally, Tom is not seeking to alter a return position for which an accuracy-related penalty has been or could be imposed. The IRS has not imposed any penalty, nor is one appropriate. No accuracy-related penalty may be imposed if there was reasonable cause and the taxpayer acted in good faith.[52] It is clear that a taxpayer's ignorance of the law gives rise to reasonable cause. Indeed, the IRS's own Internal Revenue Manual acknowledges that in some instances taxpayers may not be aware of specific obligations to file returns and/or pay taxes, recognizes that reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances such as the level of complexity of a tax or compliance issue, and concedes that a taxpayer may have reasonable cause for noncompliance if he was unaware of a requirement and could not reasonably be expected

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to know the requirement.[53] It is also clear from the regulations that reasonable reliance in good faith on advice from a professional tax advisor generally negates any accuracy-related penalties.[54] In this case, Tom was understandably ignorant of the applicable international tax rules and elections. Moreover, Tom reasonably relied on advice from Ace, a qualified tax professional, who was aware of all the relevant facts. For these reasons, accuracy-related penalties have not and could not be imposed.

Even if Tom acted reasonably and in good faith, the IRS will not grant him an extension if the IRS's interests would be prejudiced by doing so. Here, the interests of the IRS are fully preserved. If Tom had made a timely tax-deferral election back in 1999, he would not have any federal income tax liability with respect to the Canadian plans. Likewise, Tom will not have any liability with respect to the Canadian plans if the IRS grants this extension request. There is no prejudice, therefore, to the interests of the IRS.

The interests of the IRS are "ordinarily" prejudiced if the year in which the regulatory election should have been made (*i.e.*, 1999) or any years that would have been affected if the taxpayer had made the election in such year (*i.e.*, 2000 through 2006) are closed by the general three-year statute of limitations. Even though the IRS's interests may ordinarily be prejudiced if it grants relief for closed years, this is not true in Tom's case. He would not have owed any tax on the amounts in question had he made an election at the first possible opportunity, and he will not have any tax liability if the IRS grants this ruling request.

6. Conclusion

The U.S. international tax rules are complex in general, but they can prove particularly challenging to Canadians who become U.S. residents or citizens. Before moving south, many Canadians engage in some prudent retirement planning by establishing RRSPs and RRIFs, making periodic contributions, and watching their nest egg grow. Upon arriving in the United States, these newcomers (mistakenly) believe that their Canadian accounts enjoy the favorable tax treatment offered to domestic IRAs, Code Sec. 401(k) plans, and similar retirement devices. The tax advisors that these newcomers retain often share this erroneous assumption. As a result, the taxpayers fail to make the tax-deferral election contemplated by the Treaty, pay the annual U.S. tax on the passive income accumulating in the Canadian plans, and file all of the necessary information returns each year. Such failures can give rise to significant back taxes, penalties and interest.

As this article demonstrates, all is not lost for those who find themselves in a similar situation. The important thing is not to compound the problem by taking shortcuts during the clean-up process. Some taxpayers bury their heads in the sand when confronted with an unpleasant tax situation. Others try to hastily resolve the problem by filing the fewest number of forms and returns possible, rectifying their behavior on a prospective basis, and simply hoping that the IRS never selects them for audit. Neither denial nor corner-cutting is advisable for Canadians with undisclosed retirement plans because potential liabilities can be mammoth and assessment periods for many prior years may still be open. The better solution is to file an extension request with the assistance of a tax professional who understands the U.S. tax requirements associated with Canadian RRSPs and RRIFs, the elaborate procedures for seeking a PLR, and the intricacies of Reg. §301.9100-3. Seeking administrative relief at this juncture seems particularly wise given the recent focus on retirement plans by Canadian and American tax authorities in connection with their joint investigation of certain abusive cross-border tax schemes.

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ENDNOTES

1. For a more detailed explanation of the tax treatment of RRSPs and RRIFs under both Canadian and U.S. law, *see* R. Kent Weaver, *Pension Reform in Canada: Lessons for the United States,* 65 OHIO STATE LAW J. 45 (2004); Cynthia Blum, *U.S. Income Taxation of Cross-Border Pensions,* 31 FLORIDA TAX REV. 259 (1996).
2. Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital signed on September 26, 1980, as amended by protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997. On September 21, 2007, the U.S. Treasury Secretary and the Canadian Finance Minister signed the fifth protocol to the Treaty. The protocol must ratified by the U.S. Senate and the Canadian House of Commons. It will enter into force once the second government ratifies the protocol or on January 1, 2008, whichever is later. The current Treaty has no rule regarding *contributions to* retirement plans, which means there are no assurances that they may be deducted in the country of employment. Article 13 of the fifth protocol creates rules for contributions. The rules concerning income accrued in the retirement plans remain essentially unchanged.
3. Treaty, Article XVIII (Pensions and Annuities).
4. Rev. Proc. 89-45, Section 3.01 , 1989-2 CB 596.
5. Rev. Proc. 89-45, Section 3.02 , 1989-2 CB 596.
6. *Id.*
7. Rev. Proc. 2002-23, Sections 1 and 3, 2002-1 CB 744; Notice 96-31.
8. Rev. Proc. 2002-23, Section 4, 2002-1 CB 744.
9. Rev. Proc. 2002-23, Section 4.05, 2002-1 CB 744.

[10] Code Sec. 6048. Unless otherwise stated, all references herein to "Section" or "Sections" are to the Internal Revenue Code of 1986, as amended.
[11] Code Sec. 6677.
[12] Notice 2003-57, Section 2, IRB 2003-34.
[13] *Id.*
[14] Notice 2003-75, Section 2, IRB 2003-50.
[15] Notice 2003-75, Section 3, IRB 2003-50. This change came in the wake of lobbying by various groups, including the American Institute of Certified Public Accountants. *See AICPA Comments on Foreign Trust Information Return Form,* 2003 TAX NOTES TODAY 124-55 (June 19, 2003).
[16] Code Sec. 6048(d)(4).
[17] Notice 2003-75, Section 3.
[18] Instructions to Form 8891 (Rev. Dec. 2006).
[19] Instructions to Form TD F 90-22.1 (Rev. July 2000); 31 U.S.C. § 5314(a); 31 C.F.R. §103.24.
[20] Instructions to Form TD F 90-22.1 (Rev. July 2000).
[21] Instructions to Form TD F 90-22.1 (Rev. July 2000).
[22] For a complete discussion of issues related to the FBAR, *see* Hale E. Sheppard, *Evolution of the FBAR: Where We Were, Where We Are, and Why It Matters,* 7(1) UNIVERSITY OF HOUSTON BUSINESS & TAX LAW J. 1-41 (2006).
[23] *See, e.g.,* Vernon K. Jacobs, *Reporting and Disclosing Foreign Financial Accounts,* 36(6) TAX ADVISER (2005).
[24] Code Sec. 6662; Code Sec. 6651(a)(2).
[25] Code Sec. 6677.
[26] 31 U.S.C. § 5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).
[27] 31 U.S.C. § 5321(a)(5)(C)(i), (D)(ii) (as in effect after Oct. 22, 2004).
[28] Code Sec. 6072(a).
[29] Code Sec. 6151(a).
[30] Code Sec. 6601(a).
[31] Code Sec. 6622(a).
[32] IR-2006-121, IRS, Canada Revenue Agency Unravel Cross-Border Tax Scheme (Aug. 3, 2006).
[33] *Id.*
[34] The following scenario is a compilation of the fact patterns contained in 20 private letter rulings regarding Canadian RRSPs and RRIFs spanning from 1992 to 2006. *See*, LTR 9215045 (Jan. 14, 1992), LTR 9311016 (Dec. 17, 1992), LTR 9507021 (Nov. 17, 1994), LTR 9517017 (Jan. 26, 1995), LTR 9517044 (Jan. 31, 1995), LTR 9519055 (Feb. 16, 1995), LTR 9522020 (Mar. 1, 1995), LTR 9522047 (Mar. 7, 1995), LTR 9621021 (Feb. 21, 1996), LTR 9833014 (May 18, 1998), LTR 199949029 (Sept. 14, 1999), LTR 200019040 (Feb. 17, 2000), LTR 200152038 (Oct. 2, 2001), LTR 200329038 (Apr. 15, 2003), LTR 200435013 (May 5, 2004), LTR 200437005 (May 11, 2004), LTR 200519036 (Feb.1, 2005), LTR 200552006 (Sept. 29, 2005), LTR 200604027 (Oct. 20, 2005), and LTR 200607014 (Nov. 3, 2005).
[35] Several tax practitioners have suggested that it is also necessary to file a Form 8833 (*Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*), but the IRS has not appeared to enforce this requirement, if it even exists. *See* Renea M. Glendinning, *Reporting Requirements for Canadian Registered Retirement Savings Plans and Registered Retirement Income Funds,* FLORIDA CPA TODAY, July–Aug. 2004, at 48–51.
[36] Code Sec. 6501(a).
[37] Code Sec. 6501(c)(1).
[38] *V. Allen*, 128 TC 37, Dec. 56,851 (2007).
[39] Code Sec. 6501(c)(8).
[40] 31 U.S.C. § 5321(b)(1).
[41] This could also include Form 8833, if such information return is required. *See* note 35, *supra*.
[42] The onerous requirements for filing a PLR request are published in the first revenue procedure of each year. *See, e.g.,* Rev. Proc. 2007-1.
[43] Reg. §301.9100-1(c).
[44] Reg. §301.9100-1(b).
[45] Reg. §301.9100-3(a).
[46] Reg. §301.9100-3(b)(1).
[47] Reg. §301.9100-3(b)(3).
[48] Reg. §301.9100-3(b)(3).
[49] Reg. §301.9100-3(c)(1)(i).
[50] Reg. §301.9100-3(c)(1)(ii).
[51] Reg. §301.9100-3(a).
[52] Reg. §1.6662-1, Code Sec. 6664(c)(1), Reg. §1.6664-4(a).
[53] IRM §20.1.1.3.1.2.1 (Aug. 20, 1998).
[54] Reg. §1.6664-4(c).

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