IRS Introduces Two Unique Remedies for U.S. Persons with Unreported Canadian Retirement Plans and Accounts

By Hale E. Sheppard, Esq.

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I. Introduction

Life isn't fair. Neither is the IRS's most recent settlement initiative designed to entice taxpayers to proactively resolve their international tax noncompliance, such as failing to report foreign income, foreign accounts, foreign entities, *etc*. In both instances, some people win and some people lose, often with little or no regard to what is equitable. The key, therefore, is trying to situate oneself in the winner's camp. Among those basking in the benefits of favored status lately are certain Canadians, residing either in the United States or the homeland, who have neglected their tax-related obligations with Uncle Sam. Indeed, thanks to recent modifications to the offshore voluntary disclosure program (OVDP) and the introduction of special procedures for select expatriates, many Canadians are able to resolve their tax transgressions on terms vastly superior to those applicable to the masses. This is particularly true for persons with specific types of Canadian retirement plans. This article analyzes the unique options available to Canadians.[1]

II. How Does a Taxpayer Get Into This Mess?

To understand the issues concerning Canadians, one first needs some background about how a taxpayer can find himself in an unexpected mess with the IRS. Below is a typical scenario.

Carl Canuck, a Canadian by birth, decides to travel south, thereby becoming a U.S. resident for federal

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tax purposes. Carl may later obtain U.S. citizenship, too. Before departing, Carl opened and made contributions to a Canadian registered retirement savings plan (RRSP) and a Canadian registered retirement income fund (RRIF). He made no further contributions after relocating to the United States.

Carl is a skilled professional in his field, yet 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, Carl has essentially no international experience or investments.

Carl 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. Carl was eventually introduced to Ace Accountant, whom he believed to be adequately qualified. Carl retained Ace and then provided him with all of his tax-related documents each year, including those related to the Canadian RRSP and RRIF.

Ace had an accounting degree and regularly prepared Forms 1040 for dozens of clients, but he had no specific training for, and limited experience dealing with, international tax issues. Therefore, despite his awareness of Carl's RRSP and RRIF, Ace did not know of any special U.S. tax or reporting requirements related to them. Ace, believing that these foreign retirement instruments should simply be treated like Code Sec. 401(k) plans in the United States, did not report the accumulated-yet-undistributed income from the Canadian RRSP and RRIF on Carl's annual Forms 1040, and Carl thus paid no U.S. taxes on such income. Moreover, given his naiveté about international tax matters in general and the proper treatment of Canadian retirement instruments in particular, Ace never notified Carl that he may need to make a tax-deferral election or file any information returns with the IRS.

Years pass in this manner. Carl was never audited by the IRS; therefore, he had no knowledge that he was not in full compliance. One day 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, Carl called Ace and conveyed what he had 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 Carl. Outraged, Carl demanded that Ace immediately identify all options available to rectify the situation, minimizing to the greatest extent possible all back taxes, penalties, interest, and legal and/or accounting fees.

III. Overview of U.S. Tax and Information Requirements

Grasping the significance of the options available to holders of certain Canadian retirement accounts and expatriates first requires an understanding of the normal U.S. tax and information reporting duties. Entire articles can be (and have been) written about each of the obligations related to having a reportable interest in a foreign financial account, such as a Canadian RRSP or RRIF. This article merely provides a brief overview of such obligations for purposes of helping readers appreciate the uniqueness and magnitude of the special rules applicable to U.S. persons with these types of accounts.

A U.S. individual has several duties each year when he holds a financial interest in a foreign account whose balance surpasses the relevant thresholds: (1) report all income deposited into the account on Form 1040, (2) report all passive income (*i.e.*, interest, dividends, and capital gains and losses) generated by the account on Form 1040, (3) check the "yes" box in Part III (Foreign Accounts and Trusts) of Schedule B to Form 1040 indicating both the existence and location of the foreign account, (4) for tax years 2011 forward, include a Form 8938 (Statement of Specified Foreign Financial Assets) with Form 1040 and (5) file a Form TD F 90-22.1 (FBAR) with the designated Treasury Department office.[2] With respect to the last duty, the filing of the FBAR, certain ambiguity remains in the area of foreign retirement instruments. However, many tax professionals have long believed that an FBAR is mandated for most foreign individual retirement accounts, pension accounts and foreign trusts with foreign accounts.[3] This broad view finds support in the IRS instructions to Form 8891 (U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans), which ominously state that "[y]ou may be required to file Form TD F 90-22.1."

It should come as no surprise that failure to meet any of the preceding duties can lead to severe penal-

ties for taxpayers. For instance, even in a relatively benign case, underreporting of income triggers back taxes, accuracy-related penalties and interest charges. Moreover, if the taxpayer fails to file Form 8938 in a timely manner, then he "shall" pay a penalty of $10,000.[4] The penalty increases if the taxpayer does not rectify the problem quickly after contact from the IRS. In particular, if the taxpayer has not filed a Form 8938 within 90 days after the IRS notifies him of the problem, then, in addition to the initial penalty of $10,000, the taxpayer "shall" pay another penalty of $10,000 for each 30-day period (or portion thereof) during which he fails to file the Form 8938, with a maximum penalty of $50,000.[5] Finally, and perhaps most importantly, neglecting to file an FBAR sparks potentially huge sanctions. In the case of unintentional violations, the maximum penalty is $10,000.[6] The FBAR penalty increases significantly, though, where a taxpayer's inaction is deliberate; the IRS may assert a fine equal to $100,000 or 50 percent of the balance in the account at the time of the violation, whichever amount is larger.[7]

IV. Special Rules and Procedures for Certain Canadian Retirement Accounts

As mentioned above, the IRS has introduced special rules and procedures that apply only to U.S. persons holding Canadian RRSPs and RRIFs. Understanding the uniqueness of such rules requires some background.

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/or 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.[8]

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.[9] 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.[10]

The IRS has issued a series of documents over the years to provide guidance on election measures, starting with Rev. Proc. 89-45. 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 for the election year containing particular information.[11] 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.[12]

After more than a dozen years, Rev. Proc. 89-45 was superseded by Rev. Proc. 2002-23. 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.[13] 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.[14] 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.[15]

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The following year, the IRS issued Notice 2003-25,[16] which confirmed additional requirements related to RRSPs and RRIFs. This IRS pronouncement began by explaining that certain information reporting requirements are applicable to "foreign trusts."[17] 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.[18] 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, 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.[19] 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.[20]

Four months later, the IRS changed its tune when it issued Notice 2003-75, thereby introducing a "new simplified reporting regime." 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.[21] 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. Later, in Notice 2003-75, the IRS reversed course entirely, stating that the "new simplified reporting regime" provided all the information the IRS needs for tax-compliance purposes.[22] 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.[23] 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.[24]

> Given the complexities and uncertainties associated with Canadian retirement plans and the IRS's special procedures, persons in this predicament would benefit from contacting tax professionals with experience in this specific area and determining how best to proactively resolve the outstanding issues, before the IRS contacts them, and the opportunity disappears.

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.[25]

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V. Solutions in Past Years

Until very recently, there were two major schools of thought when it came to assisting someone like Carl Canuck, each of which had certain advantages and disadvantages.

A. Begin Proper Reporting Upon Discovery of Requirements

Ace Accountant could have started doing things correctly for Carl going forward and simply hoped that the IRS would not discover the previous transgressions. In other words, Ace could file Forms 8891 making the tax-deferral elections, check the box on Part III of Schedule B of Form 1040 indicating that Carl has an interest in foreign financial accounts in Canada, include a Form 8938 with the Form 1040 and file a timely FBAR disclosing the Canadian RRSP and RRIF.[26]

The primary benefit of this approach was the reduced cost; there would be no professional fees to examine all the tax and financial data for 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 was that it left Carl highly exposed and vulnerable to intense scrutiny by the IRS. As mentioned above, the failure to report income generated by Canadian RRSPs and RRIFs for which a tax-deferral election was not filed could spur back taxes, penalties on tax underpayments and interest charges. It could also lead to enormous sanctions for failure to file information returns, such as the FBAR and Form 8938. To make matters worse for Carl, the statute of limitations on assessment is extended in these types of cases. For one thing, the IRS has six years (not the normal three years) from the time of an FBAR violation to assert the penalty,[27] and failures to file a Form 8938 essentially serve to keep open indefinitely the assessment period on the entire Form 1040 to which the Form 8938 should have been attached.[28]

B. Request a Private Letter Ruling

Another approach was to have Carl Canuck, through qualified legal counsel, submit a private letter ruling (PLR) request to the IRS. This PLR request would seek an extension under Treas. Reg. §301.9100-3 to make an election to defer U.S. tax on any accumulated-yet-undistributed income from the Canadian RRSP or RRIF. In other words, the PLR would ask the IRS allow Carl to make a late tax-deferral election pursuant to the Treaty as of the first year that he became a U.S. person. The IRS issued numerous PLRs to this effect over the years, and the practice continued until recently.[29]

The receipt of the favorable PLR and the filing of the Forms 1040X in accordance with the PLR only solved one of Carl's noncompliance problems, *i.e.,* the unreported income. He still needed to address the FBAR issue, which, in theory, could prove much more costly. This was often handled under one of the IRS's international settlement initiatives, the two most recent of which are called the 2011 "offshore voluntary disclosure initiative" (OVDI) and the 2012 OVDP. The IRS issued guidance about these initiatives in the form of Frequently Asked Questions (FAQs). They feature a no-income-reporting-problem-means-no-FBAR-penalty rule, effectively providing that taxpayers who reported all taxable income on their Forms 1040 but inadvertently failed to file FBARs will not be penalized. Specifically, FAQ #17 states the following:

> QUESTION. I have properly reported all my taxable income but I only recently learned that I should have been filing FBARs in prior years to report my personal foreign bank account or to report the fact that I have signature authority over bank accounts owned by my employer. May I come forward under this new program to correct this?
>
> ANSWER. The purpose for the voluntary disclosure practice is to provide a way for taxpayers who did not report taxable income in the past to voluntarily come forward and resolve their tax matters. Thus, if you reported and paid tax on all taxable income but did not file FBARs, do not use the voluntary disclosure process. For taxpayers who reported, and paid tax on, all their taxable income for prior years but did not file FBARs, you should file the delinquent FBAR reports according to the instructions . . . and attach a statement explaining why the reports are filed late. . . . The IRS will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and you have not been previously contacted regarding an income tax examination or a request for delinquent returns.

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In summary, people like Carl Canuck often instituted a two-prong approach. They first obtained a favorable PLR and rectified the unreported income issue by filing Forms 1040X for the relevant years enclosing a late tax-deferral election for the Canadian RRSP and/or RRIF. Next, they filed late FBARs arguing that they should not be penalized because they meet the letter (or at least the spirit) of FAQ #17 and, even if this were not the case, penalties are not assessable in situations where reasonable cause existed for any tax noncompliance.

The main advantage of this approach was that, if the IRS grants the requested PLR, Carl would 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, Carl would have peace of mind that an IRS auditor was not perpetually poised at the threshold ready to inspect his (erroneous) treatment of the Canadian RRSP and RRIF.

The primary disadvantage to going this route was the cost to Carl. It all took money—drafting the lengthy PLR request and following its intricate procedural requirements, paying the application/user fee to the IRS and preparing the necessary Forms 1040X, FBARs and/or Forms 8938.[30] This financial burden, notes one group of accounting professionals, is often significant relative to the unreported income of the Canadian retirement accounts.[31] Another disadvantage to this approach was the risk that the IRS would assert FBAR penalties, notwithstanding FAQ #17 and the "reasonable cause" statement filed with the FBARs. Finally, some practitioners have speculated that this method might have been characterized as a "quiet disclosure" by the IRS, thereby triggering a full-blown audit without the benefit of any of the protections supplied by the OVDP.[32]

VI. Pressure on the IRS from Various Sources

Given the perceived unfairness and large number of affected people, the IRS came under pressure from various groups to develop a reasonable settlement plan. For example, certain tax practitioners published articles criticizing the IRS's handling of the issues. One piece offered the following commentary:

> It is in the IRS's best interest to get those Canadian Americans in the system with minimal effort. The rational approach would have been to advise U.S. citizens living in Canada of their tax obligations and request that they file U.S. tax returns and delinquent FBARs as soon as possible. Assuming the individuals were fully compliant in Canada, there would be no penalties imposed as a result of a failure to file tax returns or FBARs, but tax and interest could be collected. The IRS also could have granted blanket section 9100 relief to allow the inclusion of a late Form 8891 so that the Canadian Americans would not be taxed on their RRSPs. The amount of revenue generated would be small, but so would the amount of administrative effort. And many U.S. citizens who are residents in Canada would likely have become compliant in the United States. But the IRS did not take that approach.[33]

Another article emphasized the apparent indecision within the IRS about how to resolve issues related to Canadian retirement plans and how it was leaving many taxpayers in limbo.

> How to deal with RRSPs is on the IRS's radar, but it has not yet issued a consistent policy. As recently as [August 2011], IRS staffers on the OVDI hotline said that account balances in RRSPs would be excluded from the base amount on which the miscellaneous offshore penalty is assessed if the taxpayers filed a timely Form 8891 or requested section 9100 relief for a late Form 8891. But the week of the original OVDI deadline (August 31), the message from hotline staffers apparently changed. They told callers that Forms 8891 filed with a request for section 9100 relief would not be enough to exclude the high RRSP account balance from the base for the offshore penalty but that it would be effective in deferring recognition of the investments in the account . . . That leaves a lot of uncertainty for taxpayers who are deciding whether to opt out of the [OVDI].[34]

Adding to the pressure generated by the articles in various tax journals was the public position taken by certain high-ranking Canadian officials, who defended their compatriots against what they considered disproportionate penalties and adopted a do-your-own-dirty-work attitude.

> The decision by many not to participate in the 2011 OVDI was facilitated by Canada's Ministry

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> of Finance, which announced that it would not enforce an FBAR penalty against a Canadian American. Although Canada and the United States have an income tax treaty under which each country helps the other in collecting unpaid taxes, Canada concluded that the FBAR penalty did not relate to an "income tax" and therefore is not subject to the treaty. Thus, if the IRS determined an FBAR penalty against a Canadian American who declined to participate in the OVDI, it would have no way to collect unless the individual was present in the United States. Many Canadian Americans . . . will simply foreswear ever visiting the United States. In other words, through an onerous FBAR penalty regime, the IRS may have indirectly hurt the economic interaction between the United States and Canadian Americans, who presumably will now spend their vacations in the Caribbean instead of Florida.[35]

Finally, groups of tax professionals, such as the New York Society of CPAs, tendered comments to the IRS underscoring the obvious; that is, most noncompliance concerning Canadian retirement accounts was unintentional.

> While we acknowledge that ignorance is no excuse, there is a general lack of familiarity with Form 8891 by both taxpayers and tax advisers alike. Many taxpayers do not disclose such financial interests to their tax return preparer; nor do tax return preparers request such information from a taxpayer because each is unaware of the need to report the interest in an RRSP to the IRS. The taxpayers are genuinely surprised to discover that their retirement savings, which they cannot access and which are meant to be invested and growing tax-free in Canada, could be subject to U.S. tax and U.S. tax reporting.[36]

The New York Society of CPAs presented two possible solutions. It first suggested that the IRS reverse the legal presumption regarding Canadian RRSPs and RRIF, such that the IRS would assume that taxpayers intend to make a tax-deferral election upon becoming U.S. persons unless they affirmatively elect not to postpone U.S. taxation of their retirement plans. Alternatively, the New York Society of CPAs recommended introducing a more expedited and simplistic method for making late tax-deferral elections, like the one for submitting a delinquent Form 8832 to make an entity-classification election.[37]

VII. Two New Solutions from the IRS

The IRS declined to implement the specific solutions raised by the New York Society of CPAs, but it did introduce in 2012 two new procedures beneficial to U.S. persons with Canadian retirement accounts. These procedures are discussed below.

A. Solution One–Streamline Procedure

In June 2012, the IRS issued a news release announcing "a plan to help U.S. citizens residing overseas, including dual citizens, catch up with tax filing obligations and provide assistance for people with foreign retirement plan issues."[38] This so-called "Streamline Procedure" was not to take effect until September 1, 2012. U.S. persons with Canadian retirement plans were encouraged by the announcement, despite the need to wait several months for details, because of the favorable language in the news release:

> [T]he new procedures will allow resolution of certain issues related to certain foreign retirement plans (such as Canadian Registered Retirement Savings Plans). In some circumstances, tax treaties allow for income deferral under U.S. tax law, but only if an election is made on a timely basis. The streamlined procedures will be made available to resolve low compliance risk situations even though this election was not made on a timely basis.[39]

The IRS announced specifics about its new Streamline Procedure for certain U.S. expatriates on September 1, 2012. The Streamline Procedure, much to the chagrin of many Americans overseas, generally applies only to a very narrow group of people, *i.e.*, nonresident nonfilers with "low risk" Forms 1040. This merits more attention. The IRS's instructions to the Streamline Procedure explain that the following individuals are eligible: (i) U.S. citizens, (ii) who have resided outside the United States on a full-time basis since 2009, (iii) who have not filed Forms 1040 with the IRS from 2009 forward, and (iv) who present a "low level of compliance risk." With respect to the last criterion, the IRS indicated

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that a U.S. expatriate has a "low level of compliance risk" if he satisfies the following elements from 2009 to the present: the person does not owe the IRS $1,500 or more in taxes on any Form 1040; the person does not claim a refund on any Form 1040; the person did not have "material economic activity" in the United States; the person declared all income in his country of residence; the person is not under civil audit or criminal investigation by the IRS; the person has not previously received an FBAR warning letter or FBAR penalty; the person did not have a direct or indirect financial interest in, or some type of authority over, a financial account in a foreign country other than his country of residence; the person did not have a financial interest in a business entity that is located in a foreign country other than his or her country of residence; the person did not have income from sources in the United States; and the person did not engage in sophisticated tax planning or tax avoidance.

Consistent with the news release back in June 2012, the IRS's instructions to the Streamline Procedure issued on September 1, 2012, carve out special rules for U.S. citizens holding Canadian retirement plans. They state the following in this regard:

> [R]etroactive relief for failure to timely elect income deferral on certain retirement and savings plans where deferral is permitted by relevant treaty is available through this process. The proper deferral elections with respect to such arrangements must be made with the submission . . . Amended returns submitted through this [Streamline Procedure] will be treated as high risk returns and subject to examination, *except for those filed for the sole purpose of submitting late-filed Forms 8891 to seek relief for failure to timely elect deferral of income from certain retirement or savings plans where deferral is permitted by relevant treaty*.

The preceding language leaves some ambiguity regarding who, exactly, is eligible for the Streamline Procedure. This confusion is exacerbated by the information disseminated to the public by the IRS, particularly the titles of the pertinent documents. Each specifically states that the favorable treatment is limited to U.S. citizens living abroad. The initial fact sheet from the IRS was called "Information for U.S. Citizens or Dual Citizens *Residing Outside the United States*,"[40] the next IRS news release was titled "IRS Announces Efforts to Help *U.S. Citizens Overseas* Including Dual Citizens and Those with Foreign Retirement Plans,"[41] and the most recent item was deemed "Instructions for New Streamlined Filing Compliance Procedures for *Non-Resident*, Non-Filer U.S. Taxpayers." In addition to those titles, the IRS's instructions to the Streamline Procedure seem to restrict eligibility to expatriates who failed to file Forms 1040 over the past few years:

> This [Streamline Procedure] has been established for *non-resident non-filers*. Generally amended returns will not be accepted in this program. The only amended returns accepted through this program are those being filed for the sole purpose of submitting late-filed Forms 8891 to seek relief for failure to timely elect deferral of income from certain retirement or savings plans where deferral is permitted by relevant treaty. *Non-resident taxpayers* who have previously filed returns but wish to request deferral provisions will be required to submit (1) an amended return reflecting no adjustments to income deductions, or credits; and (2) all documents required . . . .

The aforementioned items from the IRS would cause one to conclude that the Streamline Procedure is designed only for nonresident nonfilers; that is, U.S. citizens living abroad who have not filed any Forms 1040 with the IRS during the relevant period. However, if one carefully reviews additional information from the IRS, it becomes evident that, when it comes to U.S. citizens with Canadian retirement accounts, the Streamline Procedure offers comfort not only to nonresident nonfilers, but also to resident filers. This conclusion is derived from the "Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer Taxpayers Questionnaire," which contains some vague guidance. The section of the Questionnaire called "Eligibility" contains four questions, the first two of which are (1) whether the taxpayer resided in the United States for any period of time since January 1, 2009, and (2) whether the taxpayer filed a Form 1040 for tax year 2009 or later. The Questionnaire then states that the taxpayer will be ineligible for the Streamline Procedure if he answered "yes" to either question, "except for taxpayers submitting amended returns solely for the purpose of requesting a retroactive deferral of income on Form 8891."

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B. Solution Two—New FAQs in Existing OVDP

Three things become manifest about the Streamline Procedure after one struggles through the ambiguities found in the IRS pronouncements. First, the Streamline Procedure generally applies only to non-filer non-residents with "low risk" Forms 1040. Second, a special exception exists for U.S. persons with certain Canadian retirement accounts, regardless of whether such persons lived in the United States and/or filed Forms 1040 with the IRS from 2009 forward. Third, the exception does not govern if the taxpayer's failure to file Forms 8891 to make the tax-deferral election and his related FBAR filing oversights were not the only sources of U.S. tax noncompliance. Thus, taxpayers with multiple components of noncompliance (*e.g.*, failure to report foreign-source income, foreign financial accounts other than Canadian retirement accounts, foreign entities, *etc.*) must seek other avenues of becoming copacetic with the IRS. One such path is examined below.

At the same time that it announced the Streamline Procedure for expatriates, the IRS also launched in late June 2012 one of its much-anticipated remedies for U.S. persons with Canadian RRSPs, RRIFs and/or "other similar Canadian plans." It came in the form of new FAQs for the OVDP. The recent guidance indicates that the IRS will allow taxpayers to make late tax-deferral elections, thereby eliminating (i) the related back taxes, accuracy-related penalties and interest charges, and (ii) the need to file a separate PLR request and incur all the resulting professional fees, administrative costs and stress. FAQ #54 establishes the following rule and provides distinct instructions to taxpayers, depending on the disclosure program in which they are participating:

> QUESTION. I have a Canadian registered retirement savings plan (RRSP), registered retirement income fund (RRIF), or other similar Canadian plan. I did not make a timely election pursuant to Article XVIII(7) of the U.S. – Canada income tax treaty to defer U.S. income tax on income earned by the RRSP or RRIF that has not been distributed, but I would now like to make an election. What should I do?
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> ANSWER. The answer depends upon whether you are participating in the OVDP announced by the IRS on January 9, 2012, the 2011 OVDI, or the 2009 OVDP.
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> [Guidance for taxpayers in the 2012 OVDP]. Taxpayers who are participating in the OVDP announced by the IRS on January 9, 2012, should provide the following information . . . A statement requesting an extension of time to make an election to defer income tax; Forms 8891 for each of the tax years and type of plan covered under the voluntary disclosure; A dated statement signed by the taxpayer under penalties of perjury describing events that led to the failure to make the election, events that led to the discovery of the failure, [and] if the taxpayer relied on a professional advisor, the nature of the advisor's engagement and responsibilities.
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> [Guidance for taxpayers in the 2011 OVDI]. Taxpayers who are participating in the 2011 OVDI should wait until they are contacted by an examiner about their case. Once they are contacted, they should inform the examiner of their desire to make an election and provide the examiner the information listed above.
>
> [Guidance for taxpayers in the 2009 OVDP]. Taxpayers who participated in the 2009 OVDP whose cases have not been resolved and closed with a Form 906 closing agreement should inform the examiner working their case of their desire to make an election and provide the examiner the information listed above. Taxpayers who participated in the 2009 OVDP whose cases have been resolved and closed with a Form 906 closing agreement who believe that the account balance of the RRSP or RRIF was included in the calculation of the . . . offshore penalty and would now like to make an election should [send certain information to the IRS]. Upon receipt of this information, the case will be assigned to an examiner. The examiner will provide the taxpayer with further instructions on making the election.

More critical from a financial standpoint, the new IRS guidance further indicates that if the IRS grants the tax-deferral election based on the materials submitted by the taxpayer under FAQ #54, then the highest balances in the previously undisclosed Canadian retirement accounts will *not* be subject to the so-called offshore/FBAR penalty in the OVDP. In this regard, the new FAQ #54.1 provides the following relief:

> QUESTION. If my election is granted, will the RRSP or RRIF balance be included in the offshore penalty base?

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ANSWER. No.

Thanks to FAQ #54 and FAQ #54.1, many U.S. persons with Canadian retirement plans should be able to get themselves into full U.S. tax compliance without incurring back taxes, penalties and interest charges related to such plans. Once those items have been excluded from the OVDP process, the taxpayer might then rely on a number of other FAQs to further reduce the potential offshore/FBAR penalty. Take, for instance, FAQ #52, which grants special treatment to a certain category of expatriates, namely, those who fully comply with their tax filing and tax payment obligations in the foreign country where they live and who generate little money (*i.e.*, $10,000 or less per year) from sources in the United States. If a taxpayer satisfies these criteria, two benefits arise: (i) the offshore/FBAR penalty is reduced from 27.5 percent to a mere five percent, and (ii) many nonfinancial assets, such as foreign real property and foreign business interests that the taxpayer purchased with funds that never improperly escaped U.S. taxation, are not subject to the offshore/FBAR penalty. An illustration of the functioning of FAQ #52 is set forth below.

> The taxpayer is a U.S. citizen who has lived and worked as a corporate executive in Country X since 1995. His income has included earnings in excess of $250,000 in each year, as well as bank interest and investment income on financial accounts that had a high aggregate balance of $1.2 million in 2009. He has paid all required taxes on his earnings and investment income in Country X in every year, but has filed no U.S. income tax returns since moving out of the United States. In addition to his financial accounts, the taxpayer has acquired a personal residence in Country X with equity of $900,000 and an automobile worth $85,000, both financed with previously taxed savings from the U.S., as well as his salary and investment earnings in Country X. Because the taxpayer was fully tax compliant in Country X, he will be eligible for a reduced offshore penalty of 5 percent of the value of the financial accounts, or $60,000. The residence and automobile will not be included in the penalty base because the funds used to acquire them were fully taxed in the Country X.[42]

Another item that might help taxpayers is FAQ #53, which is sometimes referred to as the small-account exception. It creates leniency in cases where the highest aggregate balance in the unreported foreign accounts (after excluding the balances in the Canadian RRSPs and/or RRIFS under FAQ #54.1), combined with the fair market value of foreign assets related in any manner to tax noncompliance, was less than $75,000. The offshore/FBAR penalty in such circumstances falls from 27.5 percent to 12.5 percent. An example of how FAQ #53 works follows.

> The taxpayer was born in a foreign jurisdiction and is now a U.S. citizen. He has a landscaping business in the U.S. He sends money to an account in the foreign jurisdiction that he owns jointly with his mother (who is a resident of that jurisdiction). The account never has more than $75,000 in it. He has never filed an FBAR or paid U.S. tax on the earnings from the account. He is entitled to the reduced 12.5% offshore penalty. The result would be the same for taxpayers who are U.S. citizens by birth.[43]

Taxpayers with international noncompliance may be able to benefit from special rules other than, or in addition to, FAQ #54, FAQ #54.1, FAQ #52 and FAQ #53. These do not constitute an exhaustive list; they are merely some of the items that arise with regularity in this context. Each taxpayer with Canadian retirement accounts would need to carefully review the FAQs to determine if any others could be of value.

VIII. Conclusion

As this article demonstrates, the IRS finally introduced in 2012 two procedures that might prove extremely beneficial to U.S. persons with certain Canadian retirement plans and accounts—the Streamline Procedure and the favorable OVDP terms, *i.e.*, FAQ #54 and FAQ #54.1. The initial challenge for taxpayers, of course, is being aware of these two new procedures. Equally important are a thorough understanding of the confusing eligibility requirements for the procedures, their unique functioning and the pros and cons of participation. Dealing with the IRS on sophisticated tax issues is invariably tricky, and the degree of thorniness is heightened when the situation involves disclosure of foreign assets. Given the complexities and uncertainties associated with Canadian retirement plans and the IRS's special procedures, persons in this predicament would benefit from contacting tax professionals with experience in this specific area and determining how best to proactively resolve the outstanding issues, before the IRS contacts them, and the opportunity disappears.

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ENDNOTES

[1] This article updates and supplements the author's earlier article from 2008, *When Bygones Aren't Bygones: Exploring Tax Solutions for U.S. Persons with Undeclared Canadian Retirement Plans and Accounts,* INT'L TAX J. 35, Vol. 34, No. 4 July-Aug. 2008.

[2] A U.S. person might have additional filing requirements if the foreign retirement account is held through a plan considered to be a "foreign trust" for U.S. tax purposes. This issue is addressed in the following section of the article.

[3] *See, e.g.,* Vernon K. Jacobs, *Reporting and Disclosing Foreign Financial Accounts,* TAX ADVISER, Vol. 36, No. 6 (2005).

[4] Code Sec. 6038D(d)(1); Treas. Reg. §1.6038D-8T(a).

[5] Code Sec. 6038D(d)(2); Treas. Reg. §1.6038D-8T(c).

[6] 31 USC §5321(a)(5)(B)(i) (as in effect after Oct. 22, 2004).

[7] 31 USC §5321(a)(5)(C)(i), (D)(ii) (as in effect after Oct. 22, 2004).

[8] 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 OH. STATE LAW J. 45 (2004); Cynthia Blum, *U.S. Income Taxation of Cross-Border Pensions,* 31 FL. TAX REV. 259 (1996).

[9] Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital signed on Sep. 26, 1980, as amended by protocols signed on Jun. 14, 1983, Mar. 28, 1984, Mar. 17, 1995, July 29, 1997 and Sep. 21, 2007.

[10] Treaty, Article XVIII (Pensions and Annuities).

[11] Rev. Proc. 89-45, 1989-2 CB 596, Sec. 3.01.

[12] *Id.,* Sec. 3.02.

[13] Rev. Proc. 2002-23, 2002-1 CB 744, Secs. 1 and 3; Notice 96-31, 1996-1 CB 378.

[14] *Id.,* Sec. 4.

[15] *Id.,* Sec. 4.05.

[16] Notice 2003-25, 2003-1 CB 855.

[17] Code Sec. 6048. Unless otherwise stated, all references herein to "Section" or "Sections" are to the Internal Revenue Code of 1986 ("the Code"), as amended.

[18] Code Sec. 6677.

[19] Notice 2003-57, 2003-2 CB 397, Sec. 2.

[20] *Id.*

[21] Notice 2003-75, 2003-2 CB 1204, Sec. 2.

[22] *Id.,* Sec. 3. 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 (Jun. 19, 2003).

[23] Code Sec. 6048(d)(4).

[24] *Supra* note 22.

[25] Instructions to Form 8891 (Rev. Dec. 2006).

[26] Several tax practitioners suggested that it also might have been necessary in the past to file a Form 8833 (Treaty-Based Return Position Disclosure Under Code Sec. 6114 or 7701(b)), but the IRS did not enforce such requirement. *See* Renea M. Glendinning, *Reporting Requirements for Canadian Registered Retirement Savings Plans and Registered Retirement Income Funds,* FL. CPA TODAY, Vol. 20, July/Aug. 2004, at 48-51.

[27] 31 USC §5321(b)(1).

[28] Code Sec. 6501(c)(8); U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate. JCX-4-10. Feb. 23, 2010, at 66. Similar rules regarding assessment periods apply in situations where a taxpayer fails to file proper information returns (*e.g.,* Forms 3520) for foreign retirement plans considered to be "foreign trusts" for U.S. tax purposes.

[29] *See, e.g.,* PLR 9311016 (Dec. 17, 1992), PLR 9507021 (Nov. 17, 1994), PLR 9517044 (Jan. 31, 1995), PLR 9519055 (Feb. 16, 1995), PLR 9621021 (Feb. 21, 1996), PLR 9833014 (May 18, 1998), PLR 199949029 (Sep. 14, 1999), PLR 200019040 (Feb. 17, 2000), PLR 200152038 (Oct. 2, 2001), PLR 200329038 (Apr. 15, 2003), PLR 200519036 (Feb. 1, 2005), PLR 200552006 (Sep. 29, 2005), PLR 200751012 (Sep. 19, 2007), PLR 201002030 (Sep. 28, 2009), PLR 201015027 (Jan. 6, 2010), PLR 201017032 (Jan. 22, 2010), PLR 201017033 (Jan. 22, 2010), PLR 201017034 (Jan. 21, 2010), PLR 201019013 (Jan. 26, 2010), PLR 201019015 (Jan. 25, 2010), PLR 201019016 (Jan. 25, 2010), PLR 201023049 (Mar. 12, 2010), PLR 201027016 (Mar. 22, 2010), PLR 201027017 (Mar. 31, 2010), PLR 201027019 (Mar. 22, 2010), PLR 201028014 (Apr. 9, 2010), PLR 201028015 (Apr. 7, 2010), PLR 201051018 (Sep. 21, 2010), PLR 201123024 (Mar. 7, 2011), PLR 201126013 (Mar. 23, 2011), PLR 201126018 (Mar. 24, 2011), PLR 201131017 (Apr. 26, 2011), PLR 201131020 (Apr. 21, 2011), PLR 201132007 (May 3, 2011), PLR 201138004 (Jun. 22, 2011), PLR 201138012 (Jun. 20, 2011), PLR 201210009 (Nov. 29, 2011), PLR 201210013 (Dec. 8, 2011),PLR 201213014 (Dec. 16, 2011), PLR 201219002 (Feb. 14, 2012), PLR 201219004 (Feb. 8, 2012), PLR 201220014 (Feb. 23, 2012), PLR 201222019 (Mar. 1, 2012), PLR 201222021 (Feb. 28, 2012), PLR 201224015 (Mar. 13, 2012), PLR 201225002 (Mar. 26, 2012), PLR 201226010 (Mar. 30, 2012), PLR 201230012 (Apr. 27, 2012), PLR 201232025 (May 16, 2012), PLR 201237002 (Jun. 15, 2012), PLR 201237004 (Jun. 15, 2012), PLR 201237011 (Jun. 14, 2012), PLR 201238005 (Jun. 14, 2012), PLR 201239005 (Jun. 28, 2012), PLR 201242004 (July 19, 2012) and PLR 201244013 (July 26, 2012).

[30] The onerous requirements for filing a PLR request are published in the first revenue procedure of each year. *See, e.g.,* Rev. Proc. 2013-1, IRB 2013-1.

[31] New York State Society of Certified Public Accountants. *New York CPAs Seek Changes to Process to Elect to Defer Tax on Canadian Retirement Savings Plan,* 2012 TAX NOTES TODAY 98-82 (2012).

[32] Robert B. Stack and Douglas M. Andres, *Expedited Opt-Out Needed for OVDI Participants Who Owe No Tax,* 2012 TAX NOTES TODAY 21-12 (Jan. 30, 2012) (stating that "[b]ecause she is worried that requesting retroactive treaty relief through the letter ruling process could be deemed a quiet filing, [the taxpayer] decides to enter the OVDI."); *See also* Robert Goulder, *Quiet Disclosures Get No Love from IRS,* 2010 TAX NOTES TODAY 90-1 (May 11, 2010); Marie Sapirie, *Charges Against HSBC Bank Bermuda Client Raise Quiet Disclosure Questions,* 201 TAX NOTES TODAY 98-1 (May 20, 2011).

[33] Richard Lipton, *Fear and Loathing North of the Border,* 2011 TAX NOTES TODAY 240-7 (2011); *See also* Robert B. Stack and Douglas M. Andre, *Expedited Opt-Out Needed for OVDI Participants Who Owe No Tax,* 2012 TAX NOTES TODAY 21-12 (2012).

[34] Marie Sapirie, *Treatment of Retirement Plans Unclear Under U.S. Offshore Disclosure Regime,* 2011 WORLDWIDE TAX DAILY 186-4 (2011).

[35] *Supra* note 33; *See also* David D. Stewart, *Canadian Finance Minister Criticizes FATCA, FBAR,* 2011 WORLDWIDE TAX DAILY 182-49 (2011).

[36] *Supra* note 31.

[37] *Id.*

[38] IR-2012-65 (Jun. 26, 2012).

[39] *Id.*

[40] FS-2011-13 (Dec. 2011).

[41] *Supra* note 38.

[42] U.S. IRS. Offshore Voluntary Disclosure Program Questions and Answers. Updated as of Jun. 26, 2012, FAQ #52(3).

[43] U.S. IRS. Offshore Voluntary Disclosure Program Questions and Answers. Updated as of Jun. 26, 2012, FAQ #53.

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