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A Simplified Procedure to Allow Late Filed Forms 8891 for Individuals With Canadian Retirement Plans and Relief From FBAR Penalties for Foreign Retirement Accounts 1

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Executive Summary

An individual living in the United States may own a retirement plan from another country. The Internal Revenue Service ("IRS") takes the position that certain foreign retirement accounts are foreign trusts and subject to the onerous reporting requirements of section 6048 of the Internal Revenue Code of 1986, as amended (the "Code") and the penalties of Code section 6677, if a Form 3520 or Form 3520-A is not timely filed. Most taxpayers with interests in foreign retirement savings plans are unfamiliar with these requirements.

But that is not all. Income earned in a foreign retirement account is, under United States ("U.S.") law, taxable to U.S. persons, even if not distributed. There is no deferral of U.S. income tax on income earned by foreign retirement accounts because they do not meet the definition of a "qualified" pension plan in the U.S.

The IRS is aware of this problem and developed a simplified reporting regime for one at least one country, Canada. Someone who holds a Registered Retirement Savings Plan or Registered Retirement Income Fund simply files a Form 8891 (U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans) and checks the box to defer U.S. income tax on the undistributed earnings of the plan. This filing also satisfies the Form 3520 and Form 3520-A compliance requirements. It is that simple.

What if an individual fails to timely file the Form 8891 and or wants to amend a filed Form 8891 and correctly report information from a retirement plan? There is no simple solution. The only procedure available is to file a request for a private letter ruling. This is expensive, timeconsuming, and burdensome for the taxpayer as well as the government. There has to be a better way to handle this.

There is a related issue. Individuals who are beneficiaries of foreign retirement accounts often have failed to file a Form TD F 90-22.1 (i.e., the Report of Foreign Bank and Financial Accounts commonly referred to as an "FBAR") and report the foreign financial account. There are steep civil penalties and even criminal sanctions for failing to file an FBAR. Individuals often mistakenly believe that foreign retirement accounts are not subject to the FBAR reporting rules.

There is little, if any, guidance from the IRS as to under what circumstances the IRS would impose civil penalties for failing to timely file an FBAR. Some type of safe harbor should be available to individuals so as to encourage reporting of foreign retirement accounts without the fear of being subjected to harsh civil penalties. A foreign retirement account simply is not the type of offshore account used by individuals to hide income or assets from the Service, which underscores the need for guidance in this area.

In light of the problems outlined above, this paper proposes the following:

1. The IRS issue a revenue procedure allowing taxpayers to make late Form 8891 filings without the need for a private letter ruling; and

2. A safe harbor provision allowing individuals who are beneficiaries of foreign retirement accounts to become U.S. tax compliant by filing delinquent FBARs without the fear of being subjected to harsh civil penalties for late filed FBARs.

I. Background Information

A. Overview of Canadian Registered Retirement Savings Plans

Increased globalization means that more and more tax attorneys and tax practitioners encounter individuals with international connections, and a common example is a Canadian citizen who immigrates to the United States to live and work. Often a Canadian citizen will own a retirement account established in Canada called a Registered Retirement Savings Plan or RRSP, which triggers various reporting rules and tax issues in the United States that are often unknown to the Canadian citizen.

A Canadian Registered Retirement Savings Plan ("RRSP") is a retirement account similar to an individual retirement account ("IRA") available in the United States. The RRSP's purpose is to promote savings for retirement by Canadian citizens. An RRSP must comply with restrictions set forth in the Canadian Income Tax Act, which determine such things as the amount and timing of contributions, allowable investment types, and other matters. Contributions to RRSPs are deductible from taxable income for Canadian income tax purposes, and the income earned in the account grows tax deferred in Canada. An account holder may cash out an amount from an RRSP at any age. However, any amount withdrawn qualifies as taxable income in Canada and is subject to withholding tax. Before the end of the year the account holder turns 71, the RRSP must either be cashed out or transferred to a Registered Retirement Income Fund ("RRIF") or an annuity.

B. U.S. Tax Treatment

For a Canadian living in the United States, the U.S. income tax treatment of an RRSP is quite different. The United States taxes U.S. persons on all of their income, from whatever source derived. 3

Therefore, the source of the income generally has no effect on the computation of the individual's U.S. taxable income. Under the current U.S. system, personal relationships are the basis for taxing a U.S. person, which is a defined term in the Code. U.S. persons include U.S. citizens and resident alien individuals. An alien (not a U.S. citizen) is considered a resident alien if he or she meets either the green card test (i.e., lawful permanent immigrant status) or the substantial presence test. 4

A Canadian citizen who immigrates to the United States to live and work generally is considered a resident alien because he either is a "green card" holder or has been physically present in the United States long enough to meet the substantial presence test. 5 As a resident alien, the Canadian immigrant will be taxable on his worldwide income.

Before the Canadian immigrant arrives in the United States, income generated by the RRSP assets will be tax-deferred in Canada until distribution because the RRSP is a pension plan under Canadian law. When the Canadian becomes a U.S. taxpayer, however, he is taxable on worldwide income. The RRSP, while a pension plan under Canadian law, is not a "qualified" plan under the Code. A retirement plan must meet specific requirements of Code section 401 for the plan to be considered a "qualified" plan. An RRSP does not meet those requirements. 6 From a U.S. income tax perspective, the RRSP is not entitled to deferral of tax on earnings generated on its assets-the account is an ordinary investment account.

In short, a Canadian citizen living in the United States faces U.S. income tax on the income accrued in an RRSP, even though he or she does not receive actual distributions and will owe no Canadian income tax until distributions are made. Many Canadian individuals and their tax advisors are unaware of the income reporting requirements with respect to Canadian RRSP and similar foreign retirement accounts. They wrongly believe that since an RRSP is similar to an IRA, it enjoys the same U.S. tax treatment. 7

C. Deferring U.S. Taxation on Income Accrued in a Canadian Registered Retirement Savings Plan

For the well-advised immigrant, there is a solution. An RRSP owner can elect to synchronize U.S. income tax treatment of a RRSP to Canadian income tax treatment: no current taxation of RRSP earnings, with taxation deferred until distribution. This election is based on provisions of the Article 18(7) of the income tax treaty between the United States and Canada.

The individual files Form 8891 (U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans) and checks a box on Form 8891 to defer U.S. income tax on the undistributed earnings of the plan. 8 Form 8891 is attached to a timely-filed Form 1040 (U.S. Individual Income Tax Return). The process is that simple. 9

The election to defer the taxation of the investment income accrued in a Canadian RRSP is authorized by the income tax treaty between the United States and Canada. The treaty provides, in part:

> A natural person who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization or other arrangement that is a resident of the other Contracting State, generally exempt from income taxation in that other State and operated exclusively to provide pension or employee benefits may elect to defer taxation in the firstmentioned State, subject to rules established by the competent authority of that State, with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor. 10

In short, a Canadian individual may take advantage of the United States/Canada income tax treaty by electing to defer taxation of the investment income accruing in the Canadian RRSP by filing Form 8891 with the IRS.

D. Delinquent Forms 8891 and Private Letter Ruling Requests

For the Canadian who learns of the special rules for RRSPs immediately upon arrival in the United States, the Form 8891 solution is lightweight and easily handled. However, what about a taxpayer who discovers several years late that RRSP earnings are considered taxable income in the United States, and that the Form 8891 filings have been omitted?

The individual's first thought will be to file amended income tax returns for prior years, attaching a properlycompleted Form 8891. This does not solve the problem. The election made on Form 8891 must be made with a timely-filed tax return, a return of which is filed no later than the filing deadline, including extensions.

The only solution for someone wishing to clear up prior year Form 8891 failures is to apply for a private letter ruling under the procedures of Treasury Regulation section 301.9100-3.

Typically, the relief sought in a private letter ruling is the IRS' consent to the filing of late Forms 8891s attached to a Form 1040X (Amended U.S. Individual Income Tax Return). A favorable private letter ruling typically allows an individual to elect to defer taxation of the investment income in the retirement account.

These are "no harm, no foul" situations. RRSPs are highly regulated by the Canadian government and so cannot be misused by the taxpayer. The relief sought is authorized by the income tax treaty between the United States and Canada. The U.S, government is not prejudiced by the grant of relief. taxation is deferred until a distribution is received. The RRSP investment earnings do not permanently escape taxation.

Clearly, there must be a better and easier way to resolve the issue for both the government and the taxpayer. Private letter ruling requests are costly for taxpayers-the user fee for taxpayers with income under $250,000 is now $2,000. In addition, there will be substantial legal fees to pay. This is an eye-popping amount of money for someone with a few tens of thousands in an RRSP and who simply wants to be fully U.S. tax compliant. For the government, there is a steady inbound flow of repetitive applications to which people and resources must be allocated. The resources could be better allocated elsewhere, and the Service has other, more important things to do.

This paper proposes extending the simple Form 8891 solution to allow for retroactive filing, without the need for a private letter ruling.

E. Delinquent FBARs and Other Compliance Issues

A taxpayer who is unaware of Form 8891 is probably unaware of another piece of paper: the FBAR. A foreign retirement account, such as an RRSP, is considered a foreign account that is subject to the FBAR reporting rules.

A United States person must disclose any financial interest in, or signature or other authority over, a foreign bank account, securities account, or other financial account. 11 *This information is reported on the Report of Foreign Bank and Financial Accounts*, Form TD F 90-22.1, (commonly referred to as FBAR), by U.S. persons if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year. Disclosure of the information sought on the FBAR is mandatory. 12

An individual with a foreign retirement account and unfiled FBARs is faced with a genuine dilemma. A simple solution and quick fix to the problem is for the individual to simply file the delinquent FBARs with the Service. There are, however, steep civil penalties and even criminal sanctions for not timely filing FBARs. The civil penalty can be up to $10,000 per account per year, but can be waived if the income from the account was properly reported and there was reasonable cause for failure to report. For many foreign retirement accounts, however, the income was not properly reported. In the case of a Canadian RRSP, the income was not sheltered from taxation by the filing of Form 8891, and was not reported as taxable income on Form 1040 in the absence of Form 8891. The taxpayer experiences the profound fear that a paperwork failure will cost him a significant chunk of his retirement savings.

One solution is to attach a cover letter with the delinquent FBARs explaining why the FBARs are filing late with the hope that the IRS will not impose any penalties under the reasonable cause exception discussed above. But there are no guarantees, and the act of filing several delinquent FBARs may draw IRS scrutiny and even an IRS examination.

The IRS has yet to issue any guidance about to how it will apply FBAR penalties to foreign retirement accounts.

IRS revenue agents working delinquent FBAR cases turn to the Internal Revenue Manual ("IRM") for guidance, which provides that whenever there is an FBAR violation, the examiner will either issue the FBAR warning letter or determine a penalty. 13 The IRM further states that examiners are expected to exercise discretion, taking into account the facts and circumstances of each case in determining whether penalties should be asserted. 14 The IRM, however, is devoid of any specific guidance on handling foreign retirement accounts.

Further compounding the problem is that the individual may have unreported income with respect to the foreign retirement account. The unreported income is due to the fact that the United States taxes the individual on the investment income accruing in the foreign retirement account. A solution is to simply file amended tax returns to report the investment income. Yet the act of filing amended tax returns may trigger an IRS examination as the IRS monitors the filing of amended tax returns and discourages so-called "quiet disclosures."

A related issue is how far back in time an individual must file amended tax returns and report the income from the foreign retirement account. The answer turns on the particular statute of limitations that applies to the case. The government generally has three years after a return is filed in which to assess the tax, and so, in general, an individual must file amended tax returns for the last three years. 15 This is not always the case. A sixyear period for assessment of tax may apply if amounts in excess of 25 percent of the gross income reported have been omitted from the return or if the omitted income is in excess of $5,000 and is attributable to a foreign financial asset. 16 In that case, the individual may need to file amended tax returns for the last six years when making a quiet disclosure.

The act of filing amended tax returns with the IRS and reporting previously undisclosed income is referred to as a "quiet disclosure." The IRS strongly discourages individuals from making quiet disclosures and instead wants individuals to participate in the IRS Offshore Voluntary Disclosure Program, which reopened in January 2012. Question 10 of the IRS 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers states, in part:

> Taxpayers are strongly encouraged to come forward under the Voluntary Disclosure Practice to make timely, accurate, and complete disclosures. Those taxpayers making "quiet" disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years. (Emphasis added.)

A practical and real problem with the IRS Voluntary Disclosure Program is that participants face a mandatory 27.5 percent offshore penalty on the value of the foreign accounts (smaller offshore accounts face a 12.5 percent penalty). After hearing the details of the program, individuals owning retirement accounts generally are unwilling to depart with 27.5 percent of their life savings and would

rather face the risk of an examination and an opportunity to plead the equities of their case before an IRS agent or possibly a court of law. In short, the Offshore Voluntary Disclosure Program often is not a realistic option for beneficiaries of foreign retirement accounts, as the economics of the program make it prohibitive.

In light of the issues discussed above surrounding delinquent FBARs and unreported income from foreign retirement accounts, this paper provides specific recommendations that the Service can implement to encourage individuals to become compliant with their foreign retirement accounts without the fear of being subjected to harsh penalties.

This proposal addresses the application of FBAR penalty rules to RRSP remedial efforts. There will soon be another problem facing people who wish to repair inadvertently unreported RRSPs. This is Form 8938. In a few years, the hurdle for Canadians living in the United States who would report their RRSPs on their U.S. tax returns. Solving the FBAR problem now will also solve the fast-approaching Form 8938 problem.

II. Specific Recommendations

A. Simple Regulatory Relief for Late-Filed Form 8891

The IRS should implement a simple system to allow an individual to file a delinquent Form 8891 without the need to file a request for a private letter ruling.

This relief could be achieved by issuing a revenue procedure granting automatic relief under Treasury Regulation section 301.9100-3 for a taxpayer to file a late Form 8891.

The Commissioner has authority under Treasury Regulation sections 301.9100-1 and 301.9100-3 to grant an extension of time if a taxpayer fails to file a timely election. Treasury Regulation section 301.9100-3 provides that the Commissioner will grant an extension of time when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer has acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government.

Revenue procedures have been issued allowing relief to taxpayers for late classification elections for entities. 17 Originally, an entity seeking to make a "check the box" election had a limited time period to do so, and no easy ability to fix an error. 18

Similar expedited solutions have been found for late filing of S elections. There is authority for granting automatic relief. By way of analogy, there are two simplified methods for shareholders to request relief for late filing of S corporation elections. Under Revenue Procedure ("Rev. Proc.") 2003-43, certain eligible entities may be granted relief for failing to timely file an S corporation election if the request for relief is filed within 24 months of the due date of the election. Relief also may be granted under Rev. Proc. 2007-62 where the application for relief is filed no later than six months after the due date (with extensions) of the S corporation's tax return for such year. These procedures are to be followed in lieu of the letter ruling process previously used to obtain relief for a late election under subchapter S. A similar procedure could be implemented with respect to filing late Forms 8891.

RRSPs offer virtually no opportunity for a taxpayer to game the system because it is a government-regulated investment account. Thus, a simple system allowing relief would be unlikely to cause prejudice to the U.S. government.

In short, there are several models that can be followed to allow late filed Forms 8891. The IRS should implement one or more of these models to alleviate the administrative burden of requiring taxpayers to request letter rulings to obtain relief for late filed Forms 8891.

B. Administrative Relief from Civil Penalties for Failure to Timely file FBARs for Foreign Retirement Accounts

The IRS should provide administrative relief from the imposition of FBAR penalties to individuals who have made a good faith effort, albeit untimely, to adequately disclose a foreign retirement account in a delinquent FBAR.

One solution is to provide specific guidance in the IRM for revenue agents working delinquent FBAR cases involves foreign retirement accounts. The IRM has a section specifically dealing with the Bank Secrecy Act and the Report of Foreign Bank and Financial Accounts, TD F 90-22.1, (FBAR).19 IRS revenue agents working cases involving delinquent FBARs look to this section of the IRM for instructions as to whether to issue an FBAR warning letter, Letter 3800, or determine a penalty when working delinquent FBAR cases. The IRM currently contains no specific guidance with respect to when the IRS should impose penalties for late filed FBARs relating to foreign retirement accounts.

The IRM should foster a policy of encouraging individuals to come forth and report their foreign retirement accounts without facing the imposition of harsh penalties.

The IRM could provide a safe harbor for individuals who have filed delinquent FBARs adequately reporting the foreign retirement account prior to receiving formal contact (i.e., letter) from the IRS with respect to late filed FBARs. In that case, the IRM could instruct the IRS agent to simply issue an FBAR warning letter, Letter 3800, as opposed to determining a penalty, if the following conditions are satisfied:

1. The individual adequately disclosed the foreign retirement account in a delinquent FBAR prior to being contacted in writing by the IRS;

2. Compliance objectives would be achieved by issuing a warning letter;

3. The individual has not been previously issued a warning letter or assessed an FBAR penalty; and

4. The individual cooperated during the examination.

There is authority for treating retirement accounts as a special class of protected assets. The IRM contains specific provisions and safeguards that must be followed before an IRS agent may levy on a pension or retirement fund. The IRM contains these special provisions because it recognizes that "retirement vehicles provide for the taxpayer's future welfare." 20 The IRM instructs agents to "[u]se discretion before levying retirement income." 21 By way of a further analogy, retirement accounts are exempted from an individual's bankruptcy estate. 22

In short, there is a real need for clear guidance in the IRM to IRS revenue agents handling delinquent FBAR cases involving retirement accounts. The guidance would, in turn, foster individuals to become U.S. tax compliant.

Another possible solution is to extend the deadline for filing an FBAR to a date certain in the future, such as June 30, 2015. There is authority for extending the filing deadline, as the IRS has done this with respect to some individuals. For example, the IRS has extended the FBAR filing deadline for certain individuals with signature authority over, but no financial interest in, a reportable account. 23

As another example, the deadline for filing an FBAR has been extended from June 30, 2011 until June 30, 2012, in the case of officers and employees of investment advisors registered with the Securities and Exchange Commission when such individuals have signature authority or other authority over, but no financial interest in, the foreign financial accounts of persons that are not registered investment companies. 24

who are beneficiaries of foreign retirement accounts to report the existence of the accounts on FBARs, it should do so by providing administrative relief to the imposition of the harsh penalties associated with late filed FBARs.

III. Conclusion

This paper has attempted to provide a framework for discussion purposes with respect to the late filing of Forms 8891 and the imposition of civil penalties for late filed FBARs relating to foreign retirement accounts.

The current state of the law creates uncertainty with respect to these matters. Taxpayers need specific and constructive guidance in this area for purposes of tax planning and compliance.

Endnotes

1. This proposal was principally prepared by Philip D. W. Hodgen and Steven L. Walker , members of the State Bar of California Taxation Section as part of the annual Washington, D.C. delegation co-sponsored by the State Bar of California and the Los Angeles County Bar Association Taxation sections. The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association. Although the authors of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this paper. Back

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3 . *See* IRC §61(a). Back

4 . *See* IRC §7701(b). Back

1 . *See* IRC §7701(b)(3)(A). An alien who does not hold a green card is considered a U.S. resident for a calendar year if he is physically present in the United States for 183 or more days during that year. Back

6 . *See* Rev. Rul. 89-95, 1989-2 C.B. 131 (a Canadian registered retirement savings plan (RRSP) is not a "qualified" plan for United States tax purposes). Back

7 . *See* IRC §408(a) and (e). When an IRA is created, the earnings on the money paid into the account are exempt from tax. The money set aside and the earnings thereon will not be taxed until they are distributed to the individual, which will usually be after retirement when the individual's tax rate bracket will generally be substantially lower. Back

8 . *See* Notice 2003-75, I.R.B. 2003-50, 1204 (describes simplified reporting regime developed for taxpayers who hold interests in RRSPs and RRIFs). Back

9 . Form 8891 also provides RRSP owners with a vastly simplified replacement to the filing requirements for foreign trusts. RRSPs are foreign trusts, and as such were subject to the burdensome Form 3520 and Form 3520-A filing requirements until the creation of the streamlined Form 8891 process. Back

10 . *See* United States-Canada Income Tax Convention, Article XVIII, Pensions and Annuities 1, signed September 26, 1980, as amended by Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007. Back

11 . *See* 31 C.F.R. Reg. §1010.350. Back

12 . The existence of a foreign account is acknowledged on Schedule 13, Part III of an individual's Form 1040. Back

13 . *See* I.R.M. 4.26.16.4 (Report of Foreign Bank and Financial Accounts (FBAR)). Back

14 . *Id.* Back

15 . *See* IRC §6501(a). Back

16 . *See* IRC §6501(e)(1)(A)(i). Back

17 . *See* Rev. Proc. 200941, 2009-39 I.R.B. 439. Back

18 . *See* Rev. Proc. 2009-41. This revenue procedure provided taxpayers a method to go back three years to fix entity election mistakes. Back

19 . *See* I.R.M. 4.26.16 (Report of Foreign Bank and Financial Accounts (FBARS)). Back

20 . *See* I.R.M. 5.11.6.2 (Funds in Pension or Retirement Plans). Back

21 . *See* I.R.M. 5.11.6.1 (Retirement Income). Back

22 . *See* 11 U.S.C. §522(4)(12) (retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under Code sections 401, 403, 408, 408A, 414, 457, or 501(a)). Back

23 . *See* FinCEN Notice 2011-1, revised June 2, 2011; IRS News Release IR-2011-57. Back

24 . *See* FinCEN Notice 2011-2. Back

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