

**U.S. TAX FILING OBLIGATIONS  
FOR  
U.S. CITIZENS/CANADIAN RESIDENTS**

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- I. United States taxes US citizens and residents on worldwide income. Canada taxes Canadian residents on worldwide income. Potential double taxation is avoided, to a certain degree, by use of foreign tax credits and/or bilateral tax treaties.
- II. If a person is a US citizen, the rules for filing income tax returns and certain information returns are generally the same whether the US citizen resides in the US or abroad.
  - A. Tax filing requirements by individual.
    1. Form 1040
      - a) Interest and penalties assessed on unpaid tax liability
      - b) Late filing penalties
      - c) Non-filing penalties
    2. Report of Foreign Bank and Financial Accounts (“FBAR”)
      - a) Due by June 30<sup>th</sup> of each year for preceding calendar year
      - b) Form TD F90-22.1
      - c) Must be filed by all US citizens, residents and entities who have financial interest or signature authority over foreign financial accounts
      - d) Must report all foreign financial accounts where the person has a financial interest if the aggregate value of all accounts exceeds \$10,000 at any time during the calendar year.
      - e) A US person has a financial interest if the person:
        - 1) Is the owner of record or holder of legal title
        - 2) Is an agent, nominee, etc. on behalf of US person
        - 3) Owns directly or indirectly more than 50% of the total value of shares of stock or more than 50% of the total voting power of all shares of stock in corporation that has a foreign financial account
        - 4) Owns directly or indirectly a more than 50% interest in either a partnership’s profits or capital that has a foreign financial account

- 5) Is a trust grantor and has an ownership interest in the trust for US federal tax purposes that has a foreign financial account
  - 6) Is a beneficiary with greater than a 50% present beneficial interest in the assets or income of the trust that has a foreign financial account
  - 7) Any other entity in which US person owns directly or indirectly more than 50% of the voting power, value of equity interest or assets or interest in profits that has a foreign financial account.
- f) 2011 Offshore Voluntary Disclosure Initiative (“OVDI”)
- 1) Ended September 9, 2011
  - 2) Substantially reduced penalties
  - 3) IRS received 12,000 applications under 2011 program. 30,000 under the 2009 and 2011 programs
  - 4) So far, IRS has collected \$2.7 billion in tax, interest and penalties from 2009 and 2011 programs. Amount will increase
- g) Since the OVDI program has ended, the only program currently available is the Criminal Investigations Voluntary Disclosure Practice
- 1) Does not reduce civil penalties or other civil provisions
  - 2) Used to reduce or eliminate criminal penalties
- h) IRS is now targeting banks in several countries, including Hong Kong, Singapore, Israel and India
- i) The offshore penalty is intended to apply to all of the taxpayer’s offshore holdings that are related in any way to tax non-compliance, regardless of the form of the taxpayer’s ownership or the character of the asset. The penalty applies to all assets directly owned by the taxpayer, including financial accounts holding cash, securities or other custodial assets; tangible assets such as real estate or art; and intangible assets such as patents or stock or other interests in a U.S. or foreign business
- j) Penalties
- 1) A person who is required to file and fails to properly file may be subject to a civil penalty up to \$10,000.
  - 2) If there is a reasonable cause for the failure to file and the balance in the account is properly reported, there is no penalty
  - 3) A person who willfully fails to report an account may be subject to a civil penalty equal to the greater of \$100,000 or 50% of the value of the account at the time of violation
  - 4) Willful violations may be subject to criminal penalties
3. Form 5471 – Information Return of US Persons with Respect to Certain Foreign Corporations

- a) Must be filed with tax return
- b) All US citizens must file this form if:
  - 1) They are officers or directors of a foreign corporation if a US person has acquired at least 10% of the stock in that foreign corporation (Category 2 Filer)
  - 2) They acquire at least 10% of the stock in a foreign corporation (Category 3 Filer)
  - 3) They have control of foreign corporation for an uninterrupted period of at least 30 days during the accounting period of the foreign corporation (Category 4 Filer)
  - 4) They own 10% or more stock in a foreign corporation that is a controlled foreign corporation (“CFC”) for an uninterrupted period of 30 days or more during the taxable year and who owns that stock on the last day of the year (Category 5 Filer)
- c) Penalties
  - 1) Failure to File Information Required by Section 6038(a) (Form 5471) and Schedule M
    - a. A \$10,000 penalty is imposed for each annual accounting period of each foreign corporation for failure to furnish the required information within the time prescribed. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the US person, an additional \$10,000 penalty (per foreign corporation) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of \$50,000 for each failure
    - b. Any person who fails to file or report all of the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit under sections 901, 902 and 960. If the failure continues 90 days or more after the date the IRS mails notice of the failure to the US person, an additional 5% reduction is made for each 3-month period, or fraction thereof, during which the failure continues after the 90-day period has expired. Section 6038(c)(2) limits the amount of this penalty.

- c. Failure to file information required by section 6046 and the related regulations (Form 5471 and Schedule O).

Any person who fails to file or report all of the information requested by section 6046 is subject to a \$10,000 penalty for each such failure for each reportable transaction. If the failure continues for more than 90 days after the date the IRS mails notice of the failure, an additional \$10,000 penalty will apply for each 30-day period or fraction thereof during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of \$50,000.

- d. Criminal penalties under sections 7203, 7206 and 7207 may apply for failure to file the information required by sections 6038 and 6046.
- e. Any person required to file Form 5471 and Schedule J, M or O who agrees to have another person file the form and schedules for him or her may be subject to the above penalties if the other person does not file a correct and proper form and schedule.
- f. For tax years beginning after March 18, 2010, penalties may be imposed for undisclosed foreign financial asset understatements. No penalty will be imposed with respect to such portion of the underpayment if the taxpayer acted in good faith with respect to such portion of the underpayments. See sections 6662(j) and 6664(c) for additional information.

4. Form 8865 – Information Return of US Persons with Respect to Certain Foreign Partnerships

- a) US citizen must attach this form to their US tax returns if they are:
  - 1) A US person who controlled the foreign partnership at any time during the partnership's tax year. Control is ownership of more than a 50% interest in the capital, profits or losses in the partnership either directly or indirectly. (Category 1 Filer)

- 2) A US person who had any time during the tax year of the foreign partnership owned at least a 10% interest while the partnership was controlled by US persons who each owned at least a 10% interest. (Category 2 Filer)
- 3) A US person who contributed property to a foreign partnership and immediately after the contribution owned directly or indirectly, at least a 10% interest or the value the contributed property and any previously contributed property by that person or any related person during the 12-month period ending on the date of transfer exceeded \$100,000. (Category 3 Filer)
- 4) A US person who owns at least a 10% interest and is involved in the acquisition, disposition or a change in proportional interest in a foreign partnership. (Category 4 Filer)

b) Penalties

- 1) Failure to timely submit all information required of Category 1 and 2 filers.
  - a. A \$10,000 penalty is imposed for each tax year of each foreign partnership for failure to furnish the required information within the time prescribed. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the US person, an additional \$10,000 penalty (per foreign partnership) is charged for each 30-day period, or fraction thereof, during which the failure continues, after the 90-day period has expired. The additional penalty is limited to a maximum of \$50,000 for each failure.
  - b. Any person who fails to furnish all of the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit under sections 901, 902 and 960. If the failure continues 90 days or more after the date the IRS mails notice of the failure, an additional 5% reduction is made for each 3-month period, or fraction thereof, during which the failure continues after the 90-day period has expired. See section 6038(c)(2) for limits on the amount of this penalty.
  - c. Criminal penalties under sections 7203, 7206 and 7207 may apply for failure to file or for filing false or fraudulent information.

2) Failure to file information required of Category 3 filers.

- a. Any person that fails to properly report a contribution to a foreign partnership that is required to be reported under section 6038B and the regulations under that section is subject to a penalty equal to 10% of the fair market value (“FMV”) of the property at the time of the contribution.
- b. The penalty is subject to a \$100,000 limit, unless the failure is due to intentional disregard. In addition, the transferor must recognize gain on the contribution as if the contributed property had been sold for its FMV.

3) Failure to file information required of Category 4 filers.

- a. Any person who fails to properly report all the information requested by section 6046A is subject to a \$10,000 penalty. If the failure continues for more than 90 days after the IRS mails notice of the failure, an additional \$10,000 penalty will apply for each 30-day period (or fraction thereof) during which the failure continues after the 90-day period has expired. The additional penalty shall not exceed \$50,000.

5. Form 8858 – Information Return of US Persons with Respect to Foreign Disregarded Entities (“FDE”)

a) US persons who are tax owners of FDEs must file form if:

- 1) They are tax owners at any time during their tax year
- 2) They are category 4 or 5 filers of Form 5471
- 3) They are category 1 or 2 filers of form 8865

b) Penalties

1) Failure to file information required by section 6038(a) Form 8858 and Schedule M (Form 8858).

- a. A \$10,000 penalty is imposed for each annual accounting period of each CFC or CFP for failure to furnish the required information within the time prescribed. If the information is not filed within 90 days after the IRS has

mailed a notice of the failure to the US person, an additional \$10,000 penalty (per CFC or CFP) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of \$50,000 for each failure.

- b. Any person who fails to file or report all of the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit under sections 901, 902 and 960. If the failure continues 90 days or more after the date the IRS mails notice of the failure to the US person, an additional 5% reduction is made for each 3-month period, or fraction thereof, during which the failure continues after the 90-day period has expired. See section 6038(c)(2) for limits on the amount of this penalty.
- c. Criminal penalties under sections 7203, 7206 and 7201 may apply for failure to file the information required by section 6038.

### III. Tax Issues Concerning US Citizens/Canadian Residents

#### A. US citizens must file tax returns on an annual basis

- 1. Does not matter how long individual has been out of US
- 2. Includes individuals who are US citizens at birth due to ancestry and have never lived in US

#### B. Liability for US income tax is based on citizenship and residency

- 1. Must report worldwide income from all sources
- 2. Double taxation is generally avoided by use of foreign tax credits
  - a) Taxes paid to Canada are credited against US tax liability
  - b) Generally all US taxes are eliminated because Canadian taxes are generally higher
  - c) US law provides that expatriates can exclude up to \$91,500 (2010) of foreign earned income when computing US taxable income
  - d) Alternative Minimum Tax (“AMT”) is generally not an issue since, for taxable years beginning after December 31, 2004, there is a 100% foreign tax credit offset.

#### C. Canadian RRSP’s and RRIF’s

1. Under US law, the income and gains earned by RRSP's and RRIF's are included in taxable income on a current basis, rather than when the income is distributed
2. US tax law treats them as normal investment accounts
3. Due to this timing mismatch, double taxation can result
4. Canada-US Tax Treaty provides relief:
  - a) US persons can elect to defer recognition of the income and gains from US taxable income until the income is withdrawn from their RRSP's or RRIF's
  - b) Election is made on Form 8891, which is attached to the US tax return
  - c) Form 8891 is used to:
    - 1) Report distributions received from RRSPs and RRIFs
    - 2) Report contributions and undistributed earnings
    - 3) Make elections to defer US income tax on different income
  - d) Separate Form 8891 must be filed for each RRSP and RRIF
  - e) Not treated as foreign trust if US citizen is eligible to file Form 8891

#### D. Canadian RESP's

1. US persons living in Canada can invest in RESPs
2. Can create adverse tax consequences since US does not allow a tax free deferral of income accrued within a RESP
3. Contributor, generally a parent, is taxable on annual realized earnings within the plan
4. Distributions are then taxed for Canadian purposes when received by the beneficiary, generally the child.
5. RESP's are considered foreign trusts for US tax purposes and require filing of separate Trust returns (Form 3520-A)

#### E. Capital Gains

1. Utilization of life time exemptions for Canadian purposes can cause US tax because there is no such exemption for US purposes

#### F. State tax issues

#### G. Estate and Gift tax issues

### IV. Relinquishing US Citizenship

- A. Whether it is advantageous for tax purposes to relinquish US citizenship depends on taxpayer's economic situation
- B. Notice 2009-85, 2009-45 IRB 598, 10/15/2009 sets forth tax responsibilities of expatriation



V. Other Issues

- A. IRS Information return must now be completed in conjunction with the processing of US passport applications
- B. If tax returns have not been filed, passport renewals could be denied
  - 1. Study by US Government Accountability Office in March 2011 concluded that legislation denying US passports to individuals with outstanding tax liabilities could generate substantial collection of unpaid tax. Report indicated that using 2008 as the test year, passports were issued to persons owing approximately \$5 billion in unpaid taxes.
- C. Generally passport denial is not being currently used.

VI. Voluntary Disclosure Policy

- A. Set forth in IRM 9.5.11.0
- B. Generally must file six years of back tax returns.
- C. Provisions of Policy
  - 1. Voluntary disclosure will be considered along with other factors in determining whether criminal prosecution will be recommended for non-filing of tax returns.
  - 2. Creates no substantive or procedural rights for taxpayers – internal IRS practice and guidelines to IRS personnel
  - 3. Does not automatically guarantee immunity from prosecution, but may result in prosecution not being recommended.
  - 4. Applies only to legal income
  - 5. Communication must be truthful, timely and complete and taxpayer must cooperate with the IRS in determining correct tax liability and make a good faith arrangement to pay any tax, interest and penalties.
- D. A disclosure is timely if it is received before:
  - 1. The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to begin one.
  - 2. The IRS has received information from a third party alerting the IRS to the taxpayer's noncompliance
  - 3. The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer, or
  - 4. The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action
- E. The IRM includes examples of voluntary disclosures and what are not voluntary disclosures.