THE CROSS-BORDER BULLETIN

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What You Know Can Hurt You

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The Cross-Border Bulletin is published periodically by Gross Shuman Brizdle & Gilfillan's Cross-Border Practice Group to keep our clients and friends informed on issues and developments believed to be of interest, particularly to Canadian businesses and individuals engaging in U.S. transactions and activities.

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The U.S. tax reporting obligations of U.S. citizens resident in Canada and Canadian citizens having dual U.S. citizenship received substantial media attention in Canada last year.

Countless newspaper articles highlighted the U.S. reporting requirements, the harshness of the penalties for noncompliance and the options available to persons subject to the requirements, as did many professional bulletins, internet blogs and features in other media.

The result of all the media "buzz" may be that persons can no longer cite "I didn't know" as an excuse to show they have "reasonable cause" for their noncompliance and then avoid IRS penalties.

Simply put, the more you know and the longer you wait, the more likely it is that you will not be able to establish "reasonable cause" for your noncompliance.

U.S. Reporting Requirements

U.S. citizens that reside in Canada are required to file U.S. returns and to pay U.S. income taxes, as well as being subject to their Canadian tax obligations.

The Canada–U.S. Tax Treaty provides relief against double taxation by allowing taxpayers a U.S. foreign tax credit for taxes paid to Canada. Since Canadian income tax rates are generally higher than U.S. tax rates, the foreign tax credit is typically sufficient to offset a person's entire U.S. tax liability. Nevertheless, U.S. returns are still required to be filed and the foreign tax credit must be claimed to be allowed.

A huge portion of the estimated one million or so U.S. citizens residing in Canada are believed to be deficient in performing their U.S. income tax reporting obligations.

Foreign Bank Account Reports

Persons subject to U.S. reporting requirements are also required to file annual Foreign Bank and Financial Account Reports ("FBARs") disclosing accounts in which they own a financial interest or over which they have signature authority. The requirement is triggered if the aggregate value of a person's non-U.S. accounts exceeds $10,000. Accounts required to be disclosed include bank accounts, investment accounts and registered retirement savings plans (RRSPs).

A huge portion of Canadian residents that are subject to U.S. reporting are also believed to be deficient in their FBAR reporting.

The penalties imposed for FBAR noncompliance can be harsh. The maximum penalty imposed for a non-willful (i.e., accidental) violation is $10,000 for each undisclosed account per year and the maximum penalty for a willful (i.e., intentional) violation is the greater of $100,000 or 50% of the highest amount in each

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undisclosed foreign bank account per year.

Penalty Relief

Following rising concerns voiced by Canadian residents subject to U.S. reporting requirements and pressure from the Canadian government, the Internal Revenue Service (IRS) issued a news release on December 13, 2011. The release confirmed that the IRS will not assert failure to file and failure to pay *income tax* penalties against taxpayers who file delinquent returns and do not owe U.S. tax (such as due to the application of the foreign tax credit).

The IRS' release further advised that no FBAR penalty will apply in the case of a violation that the IRS determines was due to "reasonable cause." This begs a couple major questions, namely: what constitutes "reasonable cause," and will the IRS adhere to traditional "reasonable cause" standards when considering FBAR penalties?

Reasonable Cause

"Reasonable cause" is generally found to exist when a taxpayer exercises ordinary business care and prudence in meeting his or her tax obligations but nevertheless fails to meet those obligations. The burden of establishing "reasonable cause" is on the taxpayer.[1] In evaluating a request for "reasonable cause" consideration, the IRS looks at the facts and circumstances presented by the taxpayer, including:

- The taxpayer's history of compliance;
- Existence of circumstances beyond the taxpayer's control;
- The taxpayer's level of education (i.e., competency) and the complexity of the tax issue; and
- Whether a reasonable expectation exists that the taxpayer should have known of the filing requirement.

Ignorance of the law is never sufficient to establish "reasonable cause" unless a taxpayer made an effort to comply, such as by consulting a licensed tax professional. Further, the effort to comply must have been in "good faith," which has been interpreted to require the disclosure of relevant tax reporting information to the tax professional, including information that was not requested by such professional. Whether the IRS will adhere to traditional "reasonable cause" standards when considering FBAR penalties remains unclear.[2]

Inaction Now – Harsh Penalties Later

In the wake of all the media attention in Canada surrounding the FBAR requirements, U.S. citizens residing in Canada who fail to come into compliance may now have a very difficult time arguing they were unaware of their U.S. reporting obligations. Indeed, as awareness increases and the IRS gathers further information of foreign account holders, doing nothing to comply may not be wise.

Doing nothing presents two notable risks. First, a taxpayer's failure to act now may diminish the taxpayer's ability to establish "reasonable cause" later and may require a stronger showing of other reasonable cause factors for failing to comply.[3] Second, a taxpayer's failure to act now may provide the IRS with reason to believe that the taxpayer's failure

What You Know Can Hurt You (continued)

If you would like more information or have any comments concerning any topic, please let us know. We welcome your inquiries and input.

Submit your questions or comments by telephone at (416) 221-5600 or e-mail to:

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was deliberate (i.e., willful blindness) which, if proven by the IRS, could result in criminal penalties. In a further release issued on January 9, 2012, the IRS in fact somewhat ominously warns that "the risk for people who do not come in continues to increase."

The Third OVDP Continues Indefinitely

The IRS' January 9, 2012 release also announced its establishment of a new (third) Offshore Voluntary Disclosure Program (Third OVDP) to allow taxpayers having previously undisclosed accounts an opportunity to come forward and become compliant.

Given the existence of that mechanism for becoming compliant, taxpayers may have little to cite as an excuse for not doing so.

The Third OVDP mirrors the IRS' prior offshore voluntary disclosure initiatives in most respects, with a few significant exceptions. First, it will continue for an indefinite period of time, meaning the IRS can withdraw the program at any time. Second, the maximum penalty for a non-willful FBAR violation is 27.5% (and 12.5%, 5% and 0% in limited cases), an increase compared to the maximum 25% and 20% penalties offered in previous initiatives. Third, the IRS reserves the right to change the terms of the program at any time, without notice. The IRS' release specifically notes that it may increase penalties in the program for all or some taxpayers or for defined classes of taxpayers.

Taxpayers who feel that the terms of the Third OVDP are unfair or that the penalties are disproportionate retain the right to opt out of the program and have their cases processed under normal IRS procedures (i.e., by audit).

Given both the complexity of the issues[4] and the possible severity of the consequences of noncompliance, individuals with FBAR concerns should promptly consult with their lawyer and/or accountant to determine whether reporting is required and whether they might benefit from participation in the Third OVDP. As discussed, undue delay could be detrimental to a taxpayer's ability to avoid civil and criminal penalties.

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1 For example, in defense of failure to file penalties, the IRS' regulations require that taxpayers provide an affirmative written statement containing a declaration that it is made under penalties of perjury. CFR 301-6651-1.

2 It is not mandatory that the IRS rely on IRS regulations when interpreting "reasonable cause" for FBAR matters. However, Section 4.26.16 of the IRS' Internal Revenue Manual acknowledges that the IRS' "reasonable cause" regulations may serve as guidance for FBAR matters.

3 Failure to cure a previous violation can also result in application of penalties and necessitate proof of "reasonable cause" in order to avoid penalties.

4 For example, evaluating whether one can muster a strong showing of "reasonable cause," whether one will likely benefit from the Third OVDP and considering statute of limitation issues.