Problems With New IRS Procedures For Canadian Retirement Plans

On October 7, 2014 the IRS released Revenue Procedure 2014-55, which purports to make US tax filing easier for US citizens or residents who own Canadian Registered Retirement Savings Plans ("RRSPs") or Registered Retirement Income Funds ("RRIFs"). Almost immediately, journalists and commentators breathlessly heralded the development as a softened and practical solution for individuals that own these Canadian retirement plans.

You can't blame the commentators for their ebullience: the prior procedures for electing tax deferral were complex, expensive, and produced uncertain results. Further, even the IRS's press release hinted at merciful relief*: IRS Simplifies Procedures for Favorable Tax Treatment on Canadian Retirement Plans and Annual Reporting Requirements*. Close examination of the new procedures, however, reveals a mixed offering of good, bad, and outright confusion.

Background on electing tax deferral for RRSPs and RRIFs the harsh "Old Rules"

Article XVIII(7) of the United States – Canada Income Tax Convention (the "Treaty") provides that an individual may defer taxation on income accumulated in RRSPs and RRIFs, however, the individual must make an affirmative annual election in order to avail himself of the tax-deferred accumulation. Starting in 2004, the election to defer income in these Canadian retirement plans was made annually on the US form 8891 and included with a timely filed US income tax return.

If the individual had not timely filed US returns, or if he has missed a few years, he could not remedy this problem by simply filing the delinquent forms 8891. The only solution to the problem of unfiled (or late-filed) forms 8891 was to apply to the IRS for permission to make a late election to defer income.

Treasury Regulation 301.9100-1(c) gives the IRS the discretion to grant a taxpayer a reasonable extension of time to make a regulatory election (such as the election to defer income tax on the form 8891) provided:

1. The taxpayer acted reasonably and in good faith; and
2. Granting the extension will not prejudice the interests of the US Government.

These requirements are deceptively difficult to satisfy and do not guarantee that the

IRS will grant the taxpayer the ability to make the late election.

The process of making the application was complex and expensive. Further, the individual requesting the ability to make the late election was required to pay a user fee simply to request such relief. The user fee has varied greatly over the years. In 2010, the user fee was $4,000; in 2013 it was $10,000; and for 2014 it is $6,900. The combination of professional fees and the user fee could easily exceed the tax savings to make the election.

New Procedures to elect tax deferral for "Eligible Individuals"… the good news for some

The good news provided in the Revenue Procedure is that "Eligible Individuals" are no longer required to file form 8891 to ensure that, for US purposes, the income in an RRSP or RRIF grows tax-deferred. The even better news is that (again for Eligible Individuals) the individual does not need to apply for a ruling in order to make a late election to defer income these Canadian retirement plans.

In order to defer the income in an RRSP or RRIF the Eligible Individual need only make an election when there is a distribution from one of these types of plans. The Revenue Procedure does not provide the details as to how this election will be made, presumably that will follow at a later date.

Who is an "Eligible Individual?"… the bad news for many Canadians

Clearly, Eligible Individuals will benefit from the procedures set forth in Revenue Procedure 2014-55, however, close examination shows that many Canadians will not qualify.

According to Section 4.01 an Eligible Individual is a beneficiary of a Canadian RRSP or RRIF who, *inter alia*:

*Has satisfied **any** requirement for filing a US Federal income tax return for **each** taxable year during which the individual was a US citizen or resident.*

I've added emphasis to the two critical terms in the definition. First, in order to be classified as an Eligible Individual, the taxpayer must have satisfied ***any*** filing requirements. Note the operative term is "any" and not "all." This is a taxpayer-friendly term because it does not require the individual seeking Eligible Individual status to have filed each and every of the multiple forms and returns typically required of US citizens living abroad. The individual must demonstrate only that he made some attempt at compliance.

Second, in order to be classified as an Eligible Individual, the taxpayer must have made some attempt at compliance for***each*** taxable year. This second term is problematic for many US citizens living in Canada because many (and in my practice, I would say "most") have missed tax filing and reporting for one or more years. As a result, these US citizens residing in Canada will not be classified as Eligible Individuals and therefore will not be entitled to the simplified procedures outlined in the Revenue Procedure.

Consequences of not being an "Eligible Individual"… welcome back to the harsh 'Old Rules'

Section 4.04 of the Revenue Procedure provides that those individuals who have not satisfied *any* US tax filing obligation for*each* year must seek the consent of the IRS in order to elect deferral of the income generated by RRSPs and RRIFs. How does one

obtain the consent of the IRS in order to make this election? By following the old rules found in Treasury Regulation 301.9100-1(c) discussed above.

"Eligible Individuals" now face failure to file penalties, where none existed before

Before the new rules set forth under the Revenue Procedure, beneficiaries of Canadian RRSPs and RRIFs were required to file the form 8891 annually in order to defer the income generated by these plans. From 2004 through 2012 there was no additional penalty for failing to file the form 8891, the taxpayer was simply not allowed to defer the income generated by the plan in that year (unless he requested a ruling, see above). Starting in 2012, however, and pursuant to section 6038D of the Internal Revenue Code, beneficial interests in RRSPs and RRIFs were required to be reported on the form 8938 *unless* the form 8891 was filed. 1.6038-7T(a)(1).

Now that beneficiaries of these Canadian retirement plans may no longer use the form 8891, they must report their ownership on the form 8938. Unfortunately, the form 8938 contains a $10,000 failure to file penalty. While the Revenue Procedure makes this result clear in Sections 2, 5.01, and 5.02, it doesn't address the enhanced penalty structure that may apply.

The enhanced penalty structure is even more onerous than the failure to file penalty. If the IRS notices that the form 8938 was not filed properly, it will send a notification to the taxpayer. If the taxpayer does not respond to the IRS's inquiry within 90 days, Section 6038D(d)(2) imposes an additional $10,000 penalty for each 30 day period that elapses following the notice. Fortunately, these enhanced penalties are capped at $50,000 per year. Worse still, the willful failure to file form 8938 may result in criminal penalties per Treasury Regulation 1.3038D-8T(f)(2).

Revenue Procedure 2014-55 causes confusion and requires clarification

There is little question that the IRS intended the Revenue Procedure to be taxpayer favorable – one need look no further than the title of the press release for evidence of this. However, there are certain omissions and inconsistencies that require clarification.

Conflicting direction regarding taxability of distributions from RRSPs and RRIFs

Sections 6 and 4.02 provide that accrued income on RRSPs and RRIFs must be reported by the individual for US tax purposes. Further, Section 6 provides that the accrued income must be reported consistent with §72 of the Code. In other words, only the income from RRSPs is taxable in the U.S. when it is distributed.

This result is directly contrary to the example in Section 7, which provides that the entire amount of the distribution is subject to taxation in the U.S. This result makes sense if the contribution to the RRSP is deductible for U.S. purposes but makes no sense if the contribution is not deductible.

The Revenue Procedure needs to be clarified to make clear that:

1. If contributions to the RRSP or RRIF are deductible for U.S. purposes (Article XVIII:8 of the Treaty) then the entire amount of distributions from the RRSP will be includable in income for U.S. purposes, which is consistent with Section 7 and the taxation of US retirement plans such as Individual Retirement Plans, 401K plans, *etc*.;
2. Only if the contribution to the RRSP is nondeductible for US purposes should the

> income be subject to U.S. tax. This would be consistent with Sections 6 and 4.02.

Admittedly, Section 4.01 makes clear that the Revenue Procedure addresses only income accrual and not the deductibility of such contributions for US purposes. However, as noted above the manner in which it addresses the US taxability of such distributions is inconsistent and requires this clarification.

The effect of the Revenue Procedure on other IRS voluntary disclosures programs

The Offshore Voluntary Disclosure Program ("OVDP"), Streamlined Domestic Offshore Procedures, and Streamlined Foreign Offshore Procedures provide taxpayers a clear protocol for becoming compliant with tax and filing obligations when there have been prior-period omissions. All three of these voluntary disclosure protocols afford the participant the ability to make late elections regarding RRSPs and RRIFs by following certain rules.

What is unclear, however, is the manner in which these protocols will work with Revenue Procedure 2014-55, if at all. If the Revenue Procedure supplants the procedures found in the voluntary disclosure programs, many Canadians will be left in the unenviable position of having to request a ruling in order to defer the income generated by these common Canadian retirement plans, which will add cost, complexity, and uncertainty to their participation.

Conclusion

In simple terms the new US procedures for electing US tax deferral for Canadian RRSPs and RRIFs do not live up to their billing. While the rules under Revenue Procedure 2014-55 do afford a better option for Eligible Individuals, many Canadian residents will not qualify because they have not filed any returns for one or more tax years. As such, these individuals will be left with little choice but to seek leave to file a late election pursuant the complex, expensive, and uncertain ruling procedure.

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