Reporting Relief for US Citizens Residing in Canada

Aasim Hirji JD and Jennifer Silvius JD, LLM (US Tax)
March 9, 2020

Complying with US tax reporting is often a complex and time-consuming process for US persons living abroad. For US persons living in Canada, navigating US tax issues is even more complex because many common Canadian investment plans (including Registered Education Savings Plans ("**RESPs**") and Registered Disability Savings Plans ("**RDSPs**")) are classified as foreign trusts for US purposes, and require annual disclosure on Forms 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) and 3520-A (*Annual Information Return of Foreign Trust with a US Owner*). These forms also come with steep penalties for the failure to timely file, and many otherwise compliant taxpayers have been hit with penalties in excess of US $10,000 because of inadvertent late filings.

For US persons living in Canada, administrative relief is on the horizon that may reduce the compliance burden. As more fully discussed below and as provided in the quote following, as of March 16, 2020, Revenue Procedure 2020-17 ("**Rev. Proc. 2020-17**") provides eligible US taxpayers with an exemption from the trust reporting requirements for eligible foreign trusts:

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue proposed regulations that would modify the requirements under section 6048 to exclude eligible individuals' transactions with, or ownership of, these applicable tax-favored foreign trusts from information reporting. The Treasury Department and the IRS request comments about these and other similar types of foreign trusts that should be considered for an exemption from section 6048 reporting.

Importantly, if you were one of the many US taxpayers that were subject to penalties for failing to timely file, Rev. Proc. 2020-17 provides relief and provides a process to request abatement or a refund of penalties previously assessed or paid under I.R.C. §6677 for a historical failure to comply with these reporting requirements.

Who is eligible for this relief?

US persons who are compliant with all the requirements for filing US income tax and information returns are eligible for the new relief. Notably, this also includes former US citizens and residents who have renounced their US citizenship or surrendered their green card. In order to be deemed compliant, the US person must have reported all contributions to, earnings of or distributions from eligible foreign trusts on their personal US income tax return.

What kinds of Canadian trusts qualify for this relief?

Under Rev. Proc. 2020-17, an eligible foreign trust must fall into one of two categories: (1) Tax-Favored Foreign Retirement Trusts or (2) Tax-Favored Foreign Non-Retirement Savings Trusts. Many common Canadian savings and investment plans will qualify for this exemption, including RESPs and RDSPs, as discussed more fully below.

A foreign trust is classified as a “Tax-Favored Foreign Retirement Trust” if:

- The trust is generally exempt from income tax or otherwise favored under the rules of the foreign jurisdiction;
    1. Trusts are classified as exempt from income tax if:
        1. Contributions to the trust are deductible or excluded from income, taxed at a reduced rate, generate a tax credit or are otherwise eligible for a tax benefit (government subsidy or contribution); and
        2. Taxation of trust investment income is deferred until the assets are distributed or taxed at a reduced rate.
- Annual information reporting with respect to the trust is provided, or available, to the foreign jurisdiction’s taxing authorities;
- Only contributions with respect to income earned through the performance of personal services are permitted;
- Contributions to the trust are limited to: (i) a percentage of the annual earned income of the participant, (ii) US $50,000 annually, or (iii) US $1,000,000 over the life of the trust, which is determined based on the US Treasury Bureau of Fiscal Service foreign currency conversion rate on the last day of the tax year;
- Withdrawals from the trust are conditioned upon reaching a specified retirement age, disability or death or penalties apply to withdrawals before those conditions are met. This includes trusts that allow withdrawals for hardship, educational purposes or the purchase of a primary residence; and
- If the trust is an employer-maintained trust, (i) the trust is nondiscriminatory and a wide range of employees are eligible to make or receive contributions or accrue benefits under the trust, (ii) the trust actually provides significant benefits for a substantial majority of eligible employees, and (iii) the benefits actually provided are nondiscriminatory.

A foreign trust is classified as a “Tax-Favored Non-Retirement Savings Trust” if:

- The trust is generally exempt from income tax or otherwise tax-favored under the laws of the trust’s jurisdiction;
- Annual information reporting with respect to the trust is provided, or available, to the foreign jurisdiction’s taxing authorities;
- Contributions to the trust are limited to $10,000 or less annually or $200,000 or less on a lifetime basis, which is determined based on the US Treasury Bureau of Fiscal Service foreign currency conversion rate on the last day of the tax year; and
- Withdrawals, distributions or payments from the trust are conditioned on the provision of medical, disability or educational benefits, or apply penalties to withdrawals, distributions or payments made before such conditions are met.

What is a RESP for Canadian tax purposes?

A Canadian Education Savings Plan (“**ESP**”) is an investment vehicle designed to help individuals save towards a beneficiary’s post-secondary education. An ESP becomes a RESP when it is accepted for registration by the Canadian Minister of National Revenue. A RESP will have three main persons, (1) a “subscriber”, (2) a “promoter” and (3) a “beneficiary”.

The subscriber is the individual contributing funds to the RESP, for the benefit of the beneficiary. The money (or assets) in a RESP account is controlled by the subscriber. When the subscriber is also a US person, they have historically been considered the “grantor” of the foreign trust and responsible for filing

Forms 3520 and 3520-A. A promoter is the organization (or person) who offers the ESP to the public and can get it registered. A beneficiary is a person to which the promoter agrees to make an "educational assistance payment" to.

RESP's can be classified as individual or family plans. Individual Plans are for the benefit of a single beneficiary and have a $50,000 lifetime contribution limit per beneficiary. By contrast, family plans can have one or more beneficiaries, and the subscriber can pay up to the maximum amount ($50,000) for each beneficiary.

Do I need to continue filing US trust returns for my RESP?

No, not in most cases. A Canadian RESP will qualify as a "tax-favored non-retirement savings trust" because these plans are tax-favored in Canada and the money that is contributed to the RESP grows tax-deferred until it is removed to pay for the beneficiary's education. RESPs have annual reporting requirements and are subject to lifetime contribution limits of $50,000 Canadian per beneficiary and contributions can only be withdrawn for the beneficiary's educational expenses, or the accumulated interest in the RESP becomes taxable at normal rates, plus a 20 percent penalty. However, RESPs that are designed as family plans with more than 4 named beneficiaries can exceed the $200,000 US lifetime contribution threshold and will likely still have to be disclosed on US trust returns.

What is a RDSP for Canadian tax purposes?

A RDSP is a Canadian savings plan that is designed to assist parents and others save for the financial security of an individual who is eligible for the Canadian disability tax credit. In order to be eligible for the disability tax credit, the Canadian Revenue Agency administers the law whereby the subject person must meet one of the following criteria:

- Be blind;
- Be markedly restricted in at least one of the basic activities of daily living;
- Be significantly restricted in two or more of the basic activities of daily living (can include a vision impairment); or
- Need life-sustaining therapy.

In addition, the individual's impairment must meet all of the following:

- be prolonged, which means the impairment has lasted, or is expected to last for a continuous period of at least 12 months; and
- be present all or substantially all the time (at least 90% of the time).

Do I need to continue filing US trust returns for my RDSP?

No, not in most cases. A Canadian RDSP will qualify as a "tax-favored non-retirement savings trust" because these plans are tax-favored in Canada and the money that is contributed to the RDSP grows tax-deferred until the end of the year the beneficiary turns 59. RDSPs have annual reporting requirements and are subject to lifetime contribution limits of $200,000 Canadian. When the beneficiary withdraws from the RDSP, the portion that is made up of the contributions is not subject to tax, while the government contributions and the income/growth is taxable. Distributions from the plan are for the purpose of supporting the disabled beneficiary.

Do I need to continue filing US trust returns for my Tax Free Savings Accounts?

Yes. Unfortunately, Canadian Tax Free Savings Accounts ("**TFSAs**") are not subject to the same government requirements as RESPs and RDSPs. TFSAs do not satisfy the necessary restrictions on withdrawal and will not qualify as tax-favored foreign retirement or non-retirement trusts under Rev. Proc. 2020-17.

What if I am not currently compliant with my US tax filing obligations?

Eligible taxpayers looking to take advantage of the relief provided by Rev. Proc. 2020-17 are able to file amended returns declaring trust contributions, income and distributions.

What if I have previously paid penalties for non-compliance with US trust reporting requirements?

Taxpayers who paid or were assessed penalties under I.R.C. §6677 can file Form 843 (*Claim for Refund and Request for Abatement*) to request a refund/abatement of the penalties paid. An eligible submission must include a request for relief under Revenue Procedure 2020-17 and an explanation of how the taxpayer and the foreign trust meet the relevant requirements for requesting relief.

What if I have previously requested penalty relief under another IRS program or based on reasonable cause?

Eligible individuals who have pending relief applications with the IRS are not prevented from making claims under Rev. Proc 2020-17, as long as the claim is made within the applicable statute of limitations period.

It looks like I might be affected by this new relief…what should I do?

Overall, we commend the Treasury Department and the IRS for listening to the concerns of millions of US expats – including Canadians – living abroad. This relief is welcome. If you feel like you might be affected, professional advice is a must.