Collins Barrow
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TAX ALERT

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2011 IRS Offshore Voluntary Disclosure PROGRAM

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The U.S. Internal Revenue Service (IRS) recently announced a special voluntary disclosure initiative that should be of particular interest to U.S. citizens resident in Canada. According to the IRS press release dated February 8, 2011, the 2011 Offshore Voluntary Disclosure Program (OVDP) is "designed to bring offshore money back into the U.S. tax system and help people with undisclosed income from hidden offshore accounts get current with their taxes." If you are a U.S. citizen resident in Canada, and you have simple banking relationships in Canada such as chequing accounts, savings accounts and RRSPs, you might not think that this program has any relevance to you. After all, you probably don't consider Canada to be an "offshore" tax haven and you probably have never attempted to "hide" any income from the IRS. However, a closer look at the U.S. income tax filing requirements and foreign bank account disclosure requirements for U.S. citizens living in Canada might reveal that you have unfulfilled obligations with the IRS. If so, it is likely in your best interests to come forward voluntarily, using the 2011 OVDP or one of the IRS's other voluntary disclosure mechanisms.

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Background

This is not the first time the IRS has offered a "special" voluntary disclosure program for offshore accounts. The previous program ended on October 15, 2009, and was a resounding success as more than 15,000 voluntary disclosures were made. The IRS had expected only about 1,000. The IRS has also been clear about its focus on the tax compliance of U.S. taxpayers with international tax matters, as evidenced by IRS Commissioner Doug Shulman's comments in the OVDP press release:

> As we continue to amass more information and pursue more people internationally, the risk to individuals hiding assets offshore is increasing. This new effort gives those hiding money in foreign accounts a tough, fair way to resolve their tax problems once and for all. And it gives people a chance to come in before we find them.

Clearly, the IRS is focused on U.S. taxpayers with international tax matters. However, you might still be asking yourself how this impacts you.

What U.S. tax filing obligations are included in the OVDP?

U.S. citizens living outside the U.S. are still required to file U.S. tax returns annually with the IRS. This requirement is due to the fact that, in addition to taxing its residents, the U.S. also continues to tax its citizens regardless of where they live in the world. In most cases, the average U.S. citizen living in Canada has no U.S. source income and ultimately there is no U.S. income tax on the U.S. tax return. In such cases, the annual U.S. tax filing obligation is really just an administrative requirement that goes along with being a U.S. citizen. That said, the assumption that there will be no tax on the U.S. tax return has caused many people to become complacent in respect of these filings, and some individuals have ceased filing their U.S. returns altogether. While it is beyond the scope of this article to provide a complete listing of all of the U.S. filing requirements for U.S. citizens in Canada, a few of the more common items, beyond the personal tax return, are listed below.

1. **TDF 90-22.1 – Report of Foreign Bank and Financial Accounts (FBAR):** U.S. citizens, residents and certain other U.S. persons must report annually their direct or indirect financial interest in, or signature authority over, a financial account that is maintained with a financial institution located in a foreign country if, for any calendar year, the aggregate value of all foreign accounts exceeded $10,000 at any time during the year.

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2. **3520 – Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts:** Taxpayers must report various transactions involving foreign trusts, including creation of a foreign trust by a U.S. person, transfers of property from a U.S. person to a foreign trust, and receipt of distributions from foreign trusts.
3. **3520A – Information Return of Foreign Trust with a U.S. Owner:** Taxpayers must also report ownership interests in foreign trusts by U.S. persons with various interests in, and power over, those trusts.
4. **5471 – Information Return of U.S. Persons with Respect to Certain Foreign Corporations:** Certain U.S. persons who are officers, directors or shareholders in certain foreign corporations are required to report specific information related to the corporation.

Again, this is not an exhaustive list. However, if any one of these items applies to you and you have not already addressed the related U.S. tax reporting obligations, you should seek a complete understanding of your obligations. It may be advisable to take advantage of one of the IRS's voluntary disclosure programs.

What are the potential penalties outside the OVDP?

The IRS has the ability to impose substantial penalties for non-compliance. For example, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50% of the total balance of the foreign account. Even "non-willful" FBAR violations that the IRS determines were not due to reasonable cause are still subject to a $10,000 penalty per violation. In addition to "failure to file" penalties like the one above, the IRS may also impose a penalty for "failure to pay the amount of tax," and an "accuracy-related" penalty. In some cases, violations can even lead to criminal prosecution. Compounding the severity of these penalties is the fact that they generally apply to each tax year in question, so multiple years of non-compliance could lead to a significant accumulation of penalties, sometimes in excess of the underlying assets to which the reporting relates. These are just some of the potential penalties, but they demonstrate the significance and severity of the consequences an individual could face if caught by the IRS with unfulfilled U.S. tax filing obligations.

What relief is provided by the OVDP?

The OVDP does not provide complete relief from any and all penalties. Instead, the OVDP provides a framework to reduce significantly the magnitude of the penalties, as well as the number of penalties that would otherwise apply. The OVDP takes into account eight taxation years from 2003 to 2010 (the "look-back" period). For a Canadian resident U.S. citizen who has failed to report foreign bank accounts on an FBAR and has failed to disclose the income from these accounts on a U.S. tax return, the OVDP process limits the penalties to a one-time 25% penalty on the highest aggregate annual balance in the unreported accounts during the entire look-back period, and a 20% accuracy-related penalty or delinquency penalties on U.S. income tax that should have been paid on any unreported income. If the "offshore" accounts did not exceed $75,000 in any relevant calendar year, the 25% penalty could be reduced to 12.5%. In certain limited circumstances, such as foreign residents who were unaware of their U.S. citizenship, the penalty could be reduced further to 5%. Furthermore, if the unreported income was subject to income tax in the foreign jurisdiction, a foreign tax credit may be available to reduce or eliminate the U.S. tax, thereby limiting or altogether eliminating the penalties associated with unpaid U.S. tax. While the OVDP does not provide relief from all penalties, clearly it provides a more reasonable alternative for many taxpayers with delinquent U.S. tax filings.

What if I only failed to file FBARs?

The OVDP may not be the right program for all situations in which taxpayers have failed to meet their tax filing obligations with the IRS. There are even some scenarios in which the IRS has gone so far as to recommend other approaches where the taxpayer's fact pattern does not fit into the profile of those targeted by the OVDP. By way of example, consider a Canadian resident U.S. citizen who has always filed U.S. tax returns on a timely basis (including properly reporting the income from foreign bank accounts) but was unaware of the annual requirement to file the FBAR. In this case, the IRS states specifically that the voluntary disclosure process is meant to "provide a way for taxpayers who did not report taxable income in the past to come forward voluntarily and resolve their tax matters. Thus, if you reported and paid tax on all taxable income but did not file FBARs, do not use the voluntary disclosure process." Instead, the IRS recommends preparing and filing all delinquent FBARs and attaching a statement explaining why the reports were filed late. It is

the IRS's practice in this situation not to impose a penalty for the failure to file FBARs if there are no underreported tax liabilities and the FBARs are filed by August 31, 2011.

What is the process required by the OVDP?

The current OVDP is available to taxpayers who come forward by August 31, 2011. The IRS has established a robust process that must be followed by the taxpayer. The process includes submitting all original and amended tax returns and information returns (i.e. FBARs) for the eight-year look-back period, paying all taxes and related late-payment interest, paying the one-time penalty on the highest aggregate annual balance in the unreported foreign accounts, and paying the accuracy-related penalty or delinquency penalties as applicable on the unpaid taxes for each year. The OVDP process requires substantial preparation and diligence to properly assess which tax filing obligations were missed, which penalties should apply, and how to comply with the disclosure program itself. This fact, coupled with the complexity of the income tax filings and the significance of the potential penalties, makes it important for taxpayers to seek professional tax advice before approaching the IRS.

Summary

In these challenging financial times, governments are seeking to capture as much revenue as possible, and the U.S. clearly is no exception. The IRS has been explicit in its public communications that it has devoted, and will continue to devote, significant resources towards identifying taxpayers abroad that have failed to meet their U.S. tax filing obligations. If you are a U.S. citizen living outside the U.S., and you believe that you may have outstanding U.S. tax filing obligations, you should seek assistance to understand your filing obligations sooner rather than later. The 2011 OVDP process may provide you with the most reasonable approach to getting back onside.

Contact your Collins Barrow advisor to discuss what, if any, U.S. tax compliance obligations you have and what tax planning is required. Collins Barrow also has access to a full range of U.S.-based tax resources through our affiliation with Baker Tilley International. §

Planning with Discretionary Family Trusts

PART II

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In our *Winter 2011 Tax Alert*, we commented on some of the potential benefits that can be achieved through the use of discretionary family trusts. It is important that subsequent actions and decisions by trustees and beneficiaries do not undermine the effectiveness of the trust structure. In this article, we discuss a number of the more common administrative traps to avoid.

Allocations must be paid or payable to the recipient-beneficiary

Trustees generally have discretion to allocate all or a portion of a trust's income to one or more beneficiaries. The amount allocated to a beneficiary in a particular year is deductible in computing the trust's taxable income, and is included in computing the recipient beneficiary's income for that year (watch the "kiddie tax" where minors receive allocations). However, one of the prerequisites for the trust to obtain a deduction against income earned in a particular year is that the allocated amount must be "paid or payable" to the beneficiary in the same year. If the amount is not paid or payable in the year, the Canada Revenue Agency (CRA) likely will disallow the deduction to the trust.

The best way to satisfy the "paid or payable" requirement is to distribute monies to the recipient-beneficiaries by way of cheques deposited into the recipients' own bank accounts.

If an allocated amount is not, or cannot be, *paid* in a particular year, the trust can still obtain a deduction if the amount becomes *payable* to a beneficiary in the year. The CRA will consider the amount to be payable only if the recipient-beneficiary has a legally enforceable right to collect the amount either immediately or, where the recipient is a minor, when that minor attains legal

age. Generally, the recipient must be aware of the trust allocation and must be in possession of legally enforceable documentation by the end of the year in which the allocation is made. If these conditions are not met, the CRA likely will deny the trust a deduction for the allocated amount.

However, the mere exercise of trustee discretion to allocate income to a particular beneficiary and evidencing such discretion with a trustee resolution are not sufficient to consider an amount to be payable. The missing ingredient here is the ability of the beneficiary to enforce payment.

A beneficiary's legal right to enforce payment can be established by having the trustee issue a demand promissory note to the recipient before the end of the year, or as soon as the amount becomes known, in which the allocation is made. However, there is a caveat to this method. Certain provisions of the *Ontario Limitations Act (2002)* may restrict the rights of the holder of a demand promissory note. In particular, the note-holder may be prevented from enforcing payment on a note more than two years after a default by the debtor (i.e. a missed interest payment, failure to pay upon demand, etc.). In such cases, the CRA may seek to deny the trust a deduction for the allocated amount, as the recipient would no longer have a legally enforceable right to collect on the note.

Payments made to beneficiaries must be used for their benefit

Parents often take possession of funds allocated from a trust to a child-beneficiary. In some cases, the parents do not maintain sufficient documentation to prove that subsequent disbursements of the funds were made for the benefit of that particular child. Such practices can have negative tax consequences. Where the parents cannot demonstrate that the funds were used for the benefit of the child, the CRA likely will deny the trust a deduction for the amounts allocated to the child. In addition, the CRA may seek to apply a benefit to the parents, to be included in their income, equal to the amount received.

The CRA will treat payments to a minor child's parents (or to third parties) for the benefit of the child as having been paid to that child in circumstances where:

i. the trustees have exercised their discretion and made an allocation payable to the child;

ii. the trustees notify the parents of the discretionary allocation and the payment is made in accordance with the parents' request or direction; and

iii. it is reasonable to consider that the payment was made to benefit the child directly. Acceptable payments include those paid for the support, maintenance, care, education, enjoyment and advancement of the child, including necessities of life.

It is most prudent, however, to have trustees make cash distributions of allocated amounts by way of cheque directly to the beneficiary's bank account in the year in which the allocation is made. Payments to any third party on account of acceptable expenses can then be made directly from the beneficiary's bank account. This strategy is particularly important when dealing with adult beneficiaries.

Maintaining accurate records

In order to support a review by the CRA, trustees are required to maintain accounting and other records to document their decisions, including:

i. separate trust bank accounts with statements and cancelled cheques for all material payments, including payment of income allocated to beneficiaries;

ii. annual resolutions and/or minutes of trustee meetings documenting all material decisions made by the trustees, including allocation of income to beneficiaries;

iii. copies of all promissory notes issued to beneficiaries for allocated amounts payable; and

iv. accurate bookkeeping and accounting records, including proper receipts for all deposits and disbursements, and entries to record allocations of income to beneficiaries.

In the event of a CRA review, the absence of such records will tend to result in the CRA disallowing many expenses, including allocations made to beneficiaries. In one particular case (*The Howard Langer Family Trust v. M.N.R.,* 92 DTC 1055), the Tax Court of Canada considered a trust that kept no formal records, did not maintain a bank account, and provided no credible evidence that income was specifically allocated and paid to the beneficiaries. In the face of this lack of proper documentation, the Court denied the deductions for amounts the trust had allocated to the beneficiaries.

Save the original trust settlement property

A number of essential, prerequisite conditions must be satisfied to establish an effective trust. One such condition requires the settlor to identify and transfer some specific property to the trust. Often, a gold or silver coin or a $10 bill is used.

If the CRA does conduct an audit, it may request a review of that original settlement property. If that property is not produced, the CRA might deny the *bona fide* existence of the trust and seek to attribute all income earned by the trust to the settlor him/herself.

Remember the 21-year deemed disposition rule

A discretionary family trust is deemed to dispose of capital assets at the end of its 21st taxation year and every 21 years thereafter. Income tax is payable by the trust at those points to the extent that the fair market value of each capital asset, determined at the deemed disposition date, exceeds the trust's adjusted cost base in that particular asset. However, this income tax can be deferred if the trust property is distributed to one or more Canadian resident beneficiaries prior to the 21-year deemed disposition date. In order to defer the tax otherwise payable on each 21st anniversary date, trustees should implement careful advance planning. If these dates are missed, any deferral of the income tax otherwise available will be lost.

A number of specific technical requirements and anti-avoidance provisions must be satisfied for a trust to be effective. Look for discussion of these issues in future editions of *Tax Alert*.

Contact your Collins Barrow advisor for more information on the use of trusts in family and business planning. **§**

The Buy-Sell Component of the
SHAREHOLDERS' AGREEMENT

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It is wise for corporations and their shareholders to consider amending their shareholders' agreements periodically, as they can become out-dated over time. In particular, the structure of the buy-sell component of shareholders' agreements evolves regularly as a result of new tax legislation and interpretations of the law by the Canada Revenue Agency (CRA).

This is particularly evident in connection with spousal rollovers after death. Under normal circumstances, when a spouse dies, all property of the deceased can pass to the surviving spouse as a tax-free rollover as long as the property vests in the spouse (i.e. unconditional ownership). The CRA now takes the position that a mandatory buy-sell of the shares of a company from a deceased's estate negates the ability to use the spousal rollover rules.

The mandatory buy out, in the CRA's view, prevents the shares from vesting. There is thus no spousal rollover and the full capital gain will have to be reported on the deceased's final return. This result poses no problem if the shares are eligible for the capital gains exemption and the deceased had enough capital gains exemption to eliminate the gain. However, if these factors are not present, the lack of a spousal rollover eliminates the ability of the surviving spouse to use his or her capital gains exemption on a sale.

To alleviate this problem, modern shareholders' agreements include what are commonly referred to as put/call provisions. Such provisions give the deceased's estate the right to require the shares to be purchased from the estate, and give the surviving shareholders the right to purchase the shares from the estate. Both parties have the option to buy and sell, but neither is obligated to do so.

Buy-sell provisions should also provide enough flexibility to allow either for the company to purchase the shares from the estate, resulting in a deemed dividend, or to have the surviving shareholder(s) purchase the shares directly from the estate, resulting in a capital gain. Shareholders should inquire of their Collins Barrow advisors regarding the tax consequences that result from these options.

When structuring agreements, it is important to predetermine the buy/sell prices on an ongoing basis rather than using pre-determined valuation formulas, which can often be misleading and not representative of fair market value. Ideally, predetermined prices should be updated annually.

Where shareholders are related (non-arm's length), a valuation may be required to support the value, though the CRA might question and challenge a valuation in these circumstances. Although the CRA can challenge an agreement to value between two unrelated shareholders, it is less likely to do so.

In any event, no valuations are required until a shareholder dies. It is thus prudent to have a mechanism in place to determine fair market value, ideally by an independent business valuator.

Notwithstanding any of the above strategies, care should be taken in implementing any changes to shareholders' agreements. Some older agreements have been maintained in their original form specifically to preserve certain tax advantages that might remain valid even though more current tax laws have changed.

These comments relate to a specific issue with shareholders' agreements. Consult your Collins Barrow business advisor and your lawyer to determine whether any circumstances have changed since your original agreement was put in place. **§**

Collins Barrow publishes a quarterly Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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