

NEWS ANALYSIS

Clarification on Retirement Plans Needed in OVDI

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In the world of voluntary disclosures, Canadian and other foreign retirement accounts could become the next passive foreign investment companies. Accounts known as registered retirement savings plans (RRSPs) in Canada and similar plans in other foreign jurisdictions are a source of consternation for U.S. taxpayers participating in the IRS's offshore voluntary disclosure initiative (OVDI) that ended September 9. Like PFICs in the previous offshore voluntary disclosure program, RRSPs could throw a wrench in the works unless the IRS issues guidance to simplify their treatment and that of similar foreign accounts.

A way to deal with those accounts is needed by taxpayers who have entered the OVDI. "The issues are complex and the appropriate response . . . is less than straightforward," said Charles Rettig of Hochman, Salkin, Rettig, Toscher & Perez PC. Perhaps the most promising option, from both an administrative and a diplomatic standpoint, is for the IRS to issue an extrastatutory work-around like that developed in September 2010 for PFICs. (For prior coverage, see *Tax Notes*, Sept. 20, 2010, p. 1224, *Doc 2010-20058*, or *2010 TNT 177-3*.)

Questions Raised by RRSPs

RRSPs are the Canadian version of IRAs. Canadian taxpayers can receive a tax deduction for amounts they put in the accounts and pay tax when they start drawing down the funds during retirement. For the income earned in an RRSP to not be taxable income to a U.S. taxpayer, she must file a Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans," with her U.S. tax return.

The primary question is whether RRSPs will be included in the base amount on which the miscellaneous offshore penalty is assessed.

RRSPs raise important questions for Canadians in the OVDI, said Robert E. Ward, principal of Robert E. Ward & Associates PC, who frequently advises Canadians on U.S. tax topics. The primary question is whether RRSPs will be included in the base amount on which the miscellaneous offshore penalty is assessed. Three other questions are whether the income earned by investments in an

RRSP will be subject to tax in the year earned or if it will be eligible for deferral, how to treat a foreign mutual fund characterized as a PFIC that is owned by an RRSP if a Form 8891 was filed to defer U.S. tax, and whether the income earned by investments in an RRSP from U.S. sources will be included in the computation of U.S.-source income in determining whether the taxpayer who owns the account has more than \$10,000 of U.S.-source income.

Other types of Canadian accounts create similar questions, including registered education savings plans, tax-free savings accounts, registered retirement income funds (RRIFs), and non-qualified deferred compensation arrangements. The issues are common to foreign tax-advantaged accounts outside Canada as well.

One special consideration for Canadian accounts stems from the country's treaty with the United States. The technical explanation to the fifth protocol refers to Rev. Proc. 2002-23 in its discussion of paragraph 7 of Article XVIII of the treaty. The revenue procedure defines an eligible plan for which income from plan investments may be deferred as an "RRSP, RRIF, a registered pension plan, or a deferred profit sharing plan." (For Rev. Proc. 2002-23, 2002-1 C.B. 744, see *Doc 2002-7446* or *2002 TNT 59-7*.)

Ward wondered if that meant that any Canadian tax-advantaged savings arrangement gets the same treatment as an RRSP. He noted that the fifth protocol changed the language in Article XVIII from "pension, retirement or employee benefits" to "pension or employee benefits" for some of the years covered by the OVDI. Income that meets that description is not subject to U.S. tax in the year earned if the taxpayer made an election. One question raised by the change is how it affects the types of accounts in Canada that qualify for deferral, he said.

Normal Relief Channels Not Optimal

Taxpayers have found that they are considered noncompliant on retirement accounts for several reasons, but a common theme is that — at least before the global education resulting from the OVDI and its 2009 predecessor — expatriates often assumed that because they were subject to the rules and regulations of their new residence, they had few, if any, obligations to their home country. Confusion about or ignorance of U.S. information reporting requirements was common. Canadians with sufficient U.S. ties to bring them within the scope of federal tax laws are dismayed by the prospect of paying additional fees on top of the penalties.

Late filing Form 8891 is not automatically allowed under the initiative. Taxpayers must seek relief under reg. section 301.9100-3 in the form of a

private letter ruling. Those applications generally are granted, but the process adds time and expense for taxpayers who have already incurred legal fees and expect to pay penalties to become compliant with U.S. tax laws. (For examples of recent private letter rulings, see *Doc 2011-17464* or *2011 TNT 157-21*; *Doc 2011-17048* or *2011 TNT 152-49*; and *Doc 2011-17051* or *2011 TNT 152-48*.)

A PFIC-Like Resolution?

The solution could be relatively simple, but reaching it may not be. The PFIC solution came about after lawyers from Caplin & Drysdale and the American Bar Association Section of Taxation asked the IRS to provide relief to taxpayers who had made voluntary disclosures. Rettig, who was involved with the ABA's comments, said that practitioner comments regarding the proposed treatment of RRSPs or similar foreign accounts should include a statutory, OVDI, or FAQ basis to support the suggested resolution.

The context is also different from the PFIC problem. Niles A. Elber, a partner at Caplin who helped spearhead the PFIC proposal, said PFICs threatened to create a roadblock in the offshore voluntary disclosure program. Taxpayers were simply unable to get the information necessary to follow the statutory calculations required by the PFIC regime because the banks often lacked the records. "While the equities of the issue for people in Canada and elsewhere may be compelling, I'm not sure I see the same thing with these retirement plans," Elber said.

The application of the offshore penalty structure could be harsh for taxpayers with some foreign retirement plans, but that may not be enough to sway the IRS. "If it is not impossible or very difficult for you to comply with your reporting requirements, then I'm not sure the Service is going to have much sympathy," Elber said.

Administrative concerns are a chief consideration and appear to be the driving force behind the IRS's hard line on the OVDI. The IRS has devoted a huge amount of resources to administering the OVDI, and carveouts and new guidance diminish efficiency.

Relief Coming?

How to deal with RRSPs is on the IRS's radar, but it has not yet issued a consistent policy. As recently as a month ago, IRS staffers on the OVDI hotline said that account balances in RRSPs would be excluded from the base amount on which the miscellaneous offshore penalty is assessed if the taxpayer filed a timely Form 8891 or requested section 9100 relief for a late Form 8891. But the week of the original OVDI deadline (August 31), the message from hotline staffers apparently changed. They told callers that Forms 8891 filed with a

request for section 9100 relief would not be enough to exclude the high RRSP account balance from the base for the offshore penalty but that it would be effective in deferring recognition of the investments in the account.

For now, the IRS seems to be considering its options. Ward said that in response to questions about the treatment of RRSPs, OVDI hotline personnel told him that "practitioners should make their best arguments as to what should or should not be included in the offshore penalty base, what should or should not be subject to U.S. income taxation, and what was or was not U.S.-source income."

'Absent a practical resolution, individuals with RRSPs or similar accounts will likely not come into compliance through a voluntary disclosure or otherwise,' Rettig said.

That leaves a lot of uncertainty for taxpayers who are deciding whether to opt out of the program. "Absent a practical resolution, individuals with RRSPs or similar accounts will likely not come into compliance through a voluntary disclosure or otherwise," Rettig said. "We all share a strong desire to get noncompliant taxpayers back into compliance."

Practitioners hope that taxpayers who entered the OVDI will see some form of relief not available to those who stayed outside the program. ■