

ABATING IRS PENALTIES

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ABOUT MAX REED



Max can be reached at:

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Max solves US tax problems for Canadians including:

- Adding corporations on the UX tax implications of cross-border transactions and initial public offerings;
- Helping citizens in Canada deal with US tax issues including renouncing their US citizenship; and
- Advising Canadian investment funds on investments into the United States and receiving investments from US taxpayers.

Max is the co-author (with Dick Pound of Stikeman Elliot) of A Tax Guide for American Citizens in Canada, as well as over 20 technical and plain language articles on a wide range of cross-border tax topics. Recognized for his expertise, Max is often invited to speak at conferences and seminars for tax professionals and the general public. He was invited to testify before the Canadian House of Commons Finance Committee on the impact of US tax law on Canadians.

Prior to joining SKL, Max worked at White & Case LLP, an international law firm in new York City where he provided US tax advice to individuals, corporations, and foreign states.

He holds a BA and two law degrees from McGill University, where he won several academic and leadership awards and is admitted to the bars of BC and New York.

About Polaris Tax Counsel

- Our new firm name!
- Canada/US cross-border tax law firm
- Lawyers in Toronto and Vancouver
- We do:
 - Cross-Border Estate Planning/Inheritance
 - Cross-Border Corporate Tax planning
 - Tax and immigration services related to renunciation
 - Help with your client's tough issues
 - Disputes with IRS (including penalty resolution and voluntary disclosures)
- We don't do: compliance work

Overview of Presentation

- I. Forms and Penalty Exposure
- II. Streamlined Procedures
- III. OVDI Replacement
- IV. Reasonable Cause
- V. Conclusion

PART ONE

FORMS AND PENALTY EXPOSURE

Common International or Foreign Tax Forms Forms and Penalty Exposure

This section outlines the common International or Foreign Tax Forms used by the Internal Revenue Service (“IRS”) and the related penalty exposure.

TRANSACTION	FORM	PENALTY FOR NON-FILING
Ownership/Signatory Authority over a Foreign Bank Account	TD F 90.22-1 (“FBAR”)	USD \$10,000 for each failure to file; 50% of the account balance or USD \$100,000 (civil penalty) OR up to USD \$500,000 <u>and</u> up to 10 years imprisonment (criminal penalty)
Receipt of large gifts from foreign persons (including foreign estates)	Form 3520	Up to 25% of the tax-free value of the transfer
Ownership interest in a foreign corporation	Form 5471	USD \$10,000 for each failure, maximum USD \$50,000
Ownership interest in a foreign partnership	Form 8865	USD \$10,000 for each failure
Transfers of certain interests in a foreign partnership	Form 8865	USD \$10,000 for each failure
Transfers to a foreign trust	Form 3520	Up to 35% of the value of the distributions
Annual information form on foreign grantor trusts	Form 3520-A	Up to 35% of the value of the distributions

TRANSACTION	FORM	PENALTY FOR NON-FILING
Transfers of assets to a foreign corporation	Form 926	10% of the value of the property transferred, maximum USD \$100,000
Officer/Director of a foreign corporation	Form 5471	USD \$10,000 for each failure
Ownership in and transfers of certain foreign disregarded entities	Form 8858	USD \$10,000 for each failure
Renunciants (citizens and Green card holders)	Form 8854	Various
U.S. Citizens with specified financial assets in a foreign country	Form 8938	5% of the gross value of the trust assets
25% Foreign-Owned U.S. or Foreign Corporation Engaged in a U.S. trade or business	Form 5472	USD \$25,000 for each failure, if failure continues for more than 90 days after IRS notification, an additional penalty of USD \$25,000 will apply.

Form 3520 & 3520-A Penalties

Generally, a failure to file Form 3520 & Form 3520-A results in the automatic issuance of a USD \$10,000 penalty. Often, taxpayers erroneously file these Forms and incur the penalty. Clients need to be aware of the distinct filing deadlines for Form 3520 & Form 3520-A and the penalty exposure related to the late filings of these Forms.

Form 3520 & 3520-A Penalties Example

For example, if a taxpayer erroneously files these Forms one year for a Canadian tax-free savings account which holds CAD\$500, and they fail to timely file it the following year, the IRS will automatically levy the USD\$10,000 penalty.

This situation arises often where the IRS has not issued guidance in respect of a common Canadian financial product, such as RESPs or TFSAs.

3520/3520-A deadlines

- 3520-A is due March 15
- Can be extended until September 15 on Form 7004
- 3520 is due April 15 (not June 15 unlike instructions)
- Can be extended until October 15 but 4868 needs to be filed by October 15

PART TWO

STREAMLINED FOREIGN OFFSHORE PROCEDURES

(“Streamlined Procedures”)

Streamlined Procedures: Overview

The Streamlined Procedures is designed to allow taxpayers to enter into U.S. tax compliance by filing amended or delinquent returns.

The Streamlined Procedures allows taxpayers to report foreign financial assets and pay all taxes due where their failure to report was not the result of willful conduct.

Streamlined Procedures: Eligibility

Taxpayer's eligibility depends on numerous factors:

1. Must be an estate or individual taxpayer that failed to report all income, pay all tax and submit all required information returns (eg. FBAR)
2. Must be a U.S. citizen residing outside the U.S.
3. Must certify that their conduct was not willful. Non-willful conduct includes: conduct due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the law
4. Must not be under civil examination by the IRS for any taxable year
5. Must have a valid taxpayer identification number
6. Must certify that they have spent no more than 35 days in the U.S. for one of the three tax years for which they are filing

Streamlined Procedures: Updates

In late 2019, the IRS Commissioner announced, at a conference, that the Streamlined Procedures would be ceasing. However, the IRS has yet to release an official statement on this matter.

PART THREE

**OFFSHORE VOLUNTARY
DISCLOSURE PROGRAM**

(“OVDP”)

OVDP Overview

The OVDP allowed taxpayers to eliminate the risk of criminal liability in cases where they willfully did not disclose their foreign assets to the IRS. This was conditioned upon the taxpayers paying a fixed cost. The program was closed in Fall 2018.

OVDP Replacement: *New Voluntary Disclosure Practice for Offshore Assets*

The OVDP was replaced by a Civil Resolution Framework for Willful Violations. Under this new framework, there is no automatic protection against criminal liability or significant civil penalties.

Willful FBAR penalties will be asserted as per IRS penalty guidelines. The statutory ceiling is the greater of \$100,000 or 50% of the balance in the account at the time of the violation.

PART FOUR

**PENALTY ABATEMENT:
REASONABLE CAUSE**

Imposition of Penalties by the IRS

A failure to file certain Forms results in the automatic imposition of penalties by the IRS.

Penalty Abatement Process

1. Taxpayer receives automatically issued IRS penalty notice (“notice”)
2. Taxpayer responds to notice and outlines cause of failure satisfy U.S. reporting obligations, generally the deadline is 30 days from the date the notice was issued.
3. IRS generally denies the taxpayer’s initial penalty abatement request.
4. Generally, the taxpayer has 60 days to appeal from the date the IRS denial was issued.
5. If the IRS denies the taxpayer’s penalty abatement appeal, the taxpayer may pay the penalty or sue for a refund.

Reasonable Cause...

Certain penalties are eligible for relief based on reasonable cause.
These include penalties for:

- Failing to file a tax return
- Failing to pay on time
- Failing to deposit certain taxes as required
- Other penalties as applicable

Penalty Abatement Standard: Reasonable Cause

As per the IRS, **Reasonable Cause** is based on all the facts and circumstances of the taxpayers situation. Consideration will be given to any reason which establishes that the taxpayer used all ordinary business care and prudence to meet their Federal tax obligations but were nevertheless unable to do so.

Reasonable Cause...

There is no precise definition of what constitutes reasonable cause.
Sound reasons for failing to file a tax return or pay tax due include:

- Fire, casualty, natural disaster or other disturbances
- Inability to obtain records
- Death, serious illness, incapacitation or unavoidable absence of the taxpayer or a member of the taxpayer's immediate family
- Other reason which establishes that the taxpayer used all ordinary business care and prudence to meet their Federal tax obligations but were nevertheless unable to do so

Reasonable Cause...

Facts considered to determine reasonable cause:

- What happened and when did it happen?
- What circumstances prevented the taxpayer from paying or filing?
- What actions did the taxpayer take to file and/or pay the taxes?

***Reasonable Cause* based on the erroneous advice from the IRS**

The portion of any penalty attributable to erroneous advice by an IRS employee acting in his official capacity is waived if:

- Advice is reasonably relied on by the taxpayer;
- Advice is issued in response to a specific written request for advice by the taxpayer; and
- Taxpayer has provided adequate and accurate information in connection with the request.

***Reasonable Cause* based on the erroneous advice of a tax advisor**

Taxpayer must demonstrate that from an objective and reasonable perspective:

- The advisor was competent tax professional with sufficient expertise to justify reliance;
- They accurately provided all the necessary information to the advisor;
- They actually and reasonably relied in good faith on the advice received from the advisor;
- The advisor must actually render advice, i.e., the advisor must communicate his analysis or conclusion to the taxpayer.

Example: reasonable cause based on the *erroneous advice of a tax advisor*

Re Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

Established the test for what constitutes reasonable cause based on erroneous advice of a tax advisor.

Re Neonatology Assocs., P.A. v. Commissioner continued ...

The U.S. Tax Court rejected the Taxpayers argument that their underpayment was due to negligence. They did not establish that they engaged with due care. It concerned an employee welfare program that reduced tax liability by circumventing provisions in the IRC (tax consequences were ‘too good to be true’). Taxpayers should have been on notice.

Example: reasonable cause based on the *erroneous advice of a tax advisor*

Whitsett v. Commissioner, 113 T.C.M. (CCH) 1455, T.C. Memo. 2017-100, Court Opinion.

In Whitsett v. Commissioner, the preparer advised the improper year to report the taxpayer's stock sale proceeds.

Whitsett v. Commissioner, 113 T.C.M. (CCH) 1455, continued ...

Facts that supported the taxpayer's actual good faith reliance on the adviser's judgment include:

1. The taxpayer accepted advice that was contrary to her economic interest;
2. The stock redemption documentation provided to the taxpayer listed several dates that would confuse any lay person in determining the correct year to report such gain;
3. The taxpayer had retained the preparer's services for many years, with no prior serious IRS challenges.

Example: reasonable cause based on the *erroneous advice of a tax advisor*

Jarnagin v. United States, 134 Fed. Cl. 368 (Fed. Cl. 2017)

The mere fact that a taxpayer engages a tax professional does not excuse failures to meet U.S. tax filing obligations. In *Jarnagin v. United States*, the Court rejected the taxpayers position that their failure to file was due to reasonable cause and reliance on a tax advisor.

***Jarnagin v. United States*, 134 Fed. Cl. 368 (Fed. Cl. 2017) continued ...**

The Court found the taxpayers did not exercise ordinary care and prudence in respect of their U.S. tax filing obligations because they:

- Failed to disclose their Canadian bank accounts as U.S. citizens with Canadian resident status;
- They did not revise their tax submission with ordinary care and business prudence which included a statement that they did not maintain a bank account in Canada.

Reasonable Cause based on ignorance of the law

Ignorance of the law alone cannot constitute reasonable cause. The taxpayer may have reasonable cause for noncompliance if they were unaware of a requirement and could not have been reasonably expected to know it.

Reasonable Cause based on ignorance of the law continued ...

Ignorance of the law in conjunction with other facts and circumstances may constitute reasonable cause based on the taxpayer's:

- Education
- Tax compliance history (e.g. no previous penalties)
- Recent changes in the law or forms
- Level of complexity of the issue

Reasonable Cause Summary

Penalty abatements based on reasonable cause are issued in narrow circumstances.

Taxpayers must be aware of their filing deadlines, keep accurate records, and disclose to their accountants all of their assets and accounts.

Accountants should take special care to inform their clients about all filing deadlines and penalties related to certain late filings where applicable (e.g. Form 3520).

Reasonable Cause: delinquent international information return submission procedures

Available for taxpayers who:

- Do not need the OVDP or Streamlined Procedures
- Have not filed one or more required international information returns;
- Are not under civil or criminal IRS investigation;
- Have not been contacted by IRS about delinquent information returns.

Delinquent international information return submission procedures continued ...

Taxpayers that file the delinquent information returns should include a statement of facts that establish reasonable cause for the failure to file.

Conclusion

- Taxpayers and accountants need to be informed about the Forms and related penalty exposure.
- The Streamlined Procedures is designed to allow taxpayers to enter into U.S. tax compliance by filing amended or delinquent returns.
- Reasonable cause may be a useful tool in limited circumstances.
- The IRS is increasingly making it difficult for taxpayers to be compliant with their U.S. filing obligations due to hardline rules and closure of the OVDP and the foreseeable closure of the Streamlined Procedures.