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The Accidental American

By Gregory Sanders

PERLEY-ROBERTSON, HILL & McDOUGALL LLP/s.r.l.

Some people estimate that there are approximately one million U.S. citizens living in Canada. Surprisingly, not all of these U.S. citizens have been compliant with their U.S. filing requirements. This might have been because they were uninformed Americans who did not know of the extent of the filing requirements set out in the Internal Revenue Code (the "IRC"). Some of these individuals might not even be aware that they are U.S. citizens living in Canada because they were born to one (1) or two (2) U.S. parents and left the United States at a very young age, or were born in Canada and one or both of their parents were U.S. citizens at the time of their birth.

Some U.S. citizens obtained Canadian citizenship and then ceased to file U.S. returns on the incorrect assumption that they were no longer required to file U.S. returns. Other U.S. citizens ceased filing U.S. returns when they became Canadian residents or citizens believing that this step was sufficient to take the position that they had expatriated from the United States and were no longer subject to its laws.

Their reasons for why they have stopped filing U.S. returns can vary however, regardless of the reason, for most of these individuals it is unlikely that they have stopped filing for purposes of evading U.S. taxes since they are typically subject to much higher Canadian tax rates.

While many U.S. citizens living in Canada could file U.S. returns and not owe any U.S. tax liability because of the high Canadian tax rates, these same U.S. citizens are faced with potentially huge penalties for failing to file the information returns that should accompany the tax returns.

There are substantial penalties applicable to U.S. citizens for failing to file information returns over and above the U.S. tax returns themselves. These penalties do not relate to the failure to report income but rather to the failure to disclose to the IRS the existence of financial assets outside of the United States.

The IRS in turn has launched extensive efforts to try and collect unpaid taxes from recalcitrant U.S. citizens who have attempted to evade or avoid U.S. tax on offshore assets. The U.S. has introduced offshore voluntary disclosure programs to U.S. citizens in order for them to re-enter the U.S. system. These voluntary disclosures still require penalties of up to twenty-seven percent (27%) of the value of offshore assets. For U.S. citizens living in Canada, the voluntary disclosure program has not been a sufficient incentive for them to comply with their outstanding obligations since most U.S. citizens in this situation that have already paid Canadian tax are concerned that they will lose a substantial portion of their life savings in penalties for failure to file the information returns.

In recognition of this, U.S. citizens and the Canadian government have been making representations to the IRS in an attempt to provide relief from some of the penalties on the failure to file information returns. At the same time, recent U.S. government initiatives attempt to identify non-filing U.S. citizens living abroad. The FATCA legislation is designed to force Canadian financial institutions that have U.S. clients to disclose the names of those clients to the IRS for purposes of allowing the IRS to collect outstanding taxes and penalties from them. The Canada-U.S. Treaty further allows the IRS to request that CRA collect outstanding tax liabilities of U.S. citizens living in Canada.

Starting in 2012, U.S. citizens who have foreign financial assets must fill out a new form (Form 8938) for 2011 and subsequent years on an annual basis, pursuant to the FATCA legislation, disclosing all of their non-U.S. financial assets.

There are not many clear options for U.S. citizens who are in this predicament. Some U.S. citizens have taken advantage of the voluntary disclosure programs offered by the U.S. and paid the appropriate penalties in order to become compliant with the U.S. system in expectation that if they fail to do so, the FATCA legislation would result in the IRS being able to identify them on their own account and applying even larger penalties. Some U.S. citizens have taken what is known as a 'quiet disclosure approach' which is to file anywhere from three (3) to five (5) years of prior tax returns and information returns to the IRS in the hope that the mere filing will not attract additional penalties. Other U.S. citizens have taken advantage of the language in the IRC that allows them to make an argument of reasonable cause for why they failed to file U.S. tax returns and information returns, in the hope that the U.S. government will abate or substantially reduce the penalties that would otherwise be imposed. Still others have taken no action at all.

This area of uncertainty has made it very difficult for U.S. citizens living in Canada to determine what steps they should take in order to become compliant with the U.S. system while not being charged or subjected to the possibility of substantial penalties. While ongoing pressure is being applied to the U.S. government to attempt to grant relief from penalties on information returns for Americans living in Canada, there are currently no guarantees that such additional relief will be granted, and U.S. citizens continue to have to deal with this uncertainty.

Gregory Sanders is a lawyer in our Tax Law Group. He can be reached at gsanders@perlaw.ca or 613.566.2846.