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Ignorance is bliss, but taxes are nothing to ignore, even when owed to a foreign government

Nobody likes paying taxes; but ignoring tax obligations in the United States and Canada can have disastrous consequences for clients and advisors. Advisors should ensure that clients are aware of the actions both the U.S. and Canadian governments can take to enforce their own tax laws and the co-operation they extend to help the other government enforce its laws. Advisors should also encourage clients to consult a tax expert when necessary.

Common misperceptions

For many Canadians, the United States feels so familiar that it's almost like home. Canadians may visit the U.S., invest in American companies, and buy and sell U.S. property. However, some of these activities could result in a Canadian having to file a U.S. tax return and possibly having to pay tax to the United States, something that's not so familiar. Further, some American taxes – estate, gift and “generation skipping” taxes – are not familiar at all. Even those taxes that should be familiar, like income taxes, may be applied in ways that many Canadians, including those with dual citizenship, could find confusing.

Nevertheless, it's important for clients to recognize that even though they may not be a citizen of the United States or even live there, they must still respect its tax laws, and pay any taxes they owe to the United States (and the same applies, of course, for Americans who may owe taxes to Canada). Both the United States and Canada have a long history of cooperation in tax enforcement matters, and both taxing authorities continue to develop ways of detecting tax evasion.

Detecting tax evasion

Most people make an effort to comply with a government's requirement to file tax returns and pay tax. However, in case you have a client who may be tempted to ignore the IRS or CRA, you may want to remind them that the tax authorities on both sides of the border use many sources of information to find tax evaders:

- Spot-checks of tax filer records.
- Financial institutions must report many details of client transactions and often must withhold taxes to avoid facing financial liability and penalties themselves

- Accountants may be required to report evidence of tax crimes committed by non-clients – and sometimes even by clients.¹
- Police forces and customs officials may report evidence of tax evasion accidentally uncovered in unrelated matters.
- Unhappy customers, cranky neighbours, disgruntled former spouses and business competitors may be willing to turn in a suspected tax evader.²
- Co-operation with foreign governments and foreign government agencies.
- Applying pressure on foreign governments and on foreign financial institutions doing business with the country to disclose information about foreign accounts.³

Tax collectors are getting better at finding assets outside North America

Over the past several years, governments have enacted laws designed to fight the financing of global terrorism, to fight international money laundering associated with the illegal drug trade, and to fight tax evasion carried out by people depositing money into offshore accounts. The new laws require financial institutions to obtain more information from clients and to verify accounts and identities. They have also increased international co-operation to enforce their laws.

Tax authorities have also made efforts to obtain information about customer accounts and income in foreign countries in spite of those countries' strict secrecy laws. It is legal to implement a strategy designed to protect assets from the claims of creditors by transferring assets to financial institutions in countries outside of North America. In general, a person using the strategy relies on the foreign country's laws to protect their confidentiality and to make it more difficult to collect on judgments won in another country. Neither Canada's nor the United States' laws prevent citizens or residents from moving money or property offshore. However, clients still must report the existence of such accounts, and any income generated from them, to the appropriate tax authority, even if they believe that the tax authority could never find out about the account. Recent efforts by the tax authorities are underscoring the importance of this distinction.

Several years ago the IRS obtained court orders against VISA International, MasterCard and American Express, requiring them to disclose the names of customers owning credit cards issued by offshore banks, mostly in the Caribbean. Many of those cards were issued to U.S. customers owning bank accounts in the Caribbean, and allowed those customers easy access to their funds from anywhere in the world.

However, the IRS suspected that some Americans were failing to report income from those accounts. Since the banking secrecy laws in the individual Caribbean countries prevented the banks from disclosing any information about the accounts to the IRS, the IRS instead traced the existence of those accounts through the credit card companies, who were subject to U.S. law.

The IRS then compared card ownership with U.S. tax returns and, where it suspected tax evasion, launched investigations. Some of those investigations have resulted in prosecutions and convictions for tax evasion. The threat of investigation and the potential for prosecution has also encouraged many U.S. taxpayers to voluntarily report income from such accounts.

A more recent IRS initiative resulted in UBS Financial having to disclose the names of U.S. clients owning Swiss bank accounts with UBS, a Swiss bank with a large presence in the United States (and Canada). The IRS wanted to see if UBS' U.S. clients had disclosed the existence of their accounts to the IRS and if they had reported the income those accounts had earned. When the IRS first asked UBS for the names, UBS resisted, claiming that disclosure would violate Switzerland's banking secrecy laws. The IRS sued. Under the terms of a settlement reached in 2009, UBS agreed to disclose the names and accounts to the Swiss tax authorities, which in turn decides which names to forward to the IRS.

¹ As a result of the Supreme Court of Canada decision in *Canada v. Federation of Law Societies*, 2015, SCC 7, lawyers are exempt from the provisions in the Proceeds of Crime (Money Laundering) and Terrorist Financing Act that require financial intermediaries to collect and retain information about client transactions, and that subjects that information to search and seizure.

² The IRS has a form that anyone may use to report suspected tax evasion: <http://www.irs.gov/pub/irs-pdf/f211.pdf>. The IRS also offers rewards to those reporting suspected tax evasion if the amount in question is large enough and if the suspected evader's income is high enough. The CRA has a similar program created as part of the CRA's efforts "to fight international tax evasion and aggressive tax avoidance". Information about the program is at the following website: <http://www.cra-arc.gc.ca/gncy/cmplnc/otip-pdife/menu-eng.html>.

³ Under an intergovernmental agreement that Canada has with the United States, U.S. persons must identify themselves to a financial institution they do business with, that institution must report to the CRA, which in turn shares that information with the IRS.

Following the IRS' efforts, the CRA is negotiating with UBS to obtain the names of Canadian taxpayers who may have abused Switzerland's banking secrecy laws to hide income from the CRA in Swiss accounts.

Most recently the governments of many nations, including Canada, have signed intergovernmental agreements with the United States. Those agreements implement the provisions of the American Foreign Account Tax Compliance Act (FATCA). Under those agreements financial institutions outside the United States must collect information about their U.S. citizen customers and forward that information to their own tax authorities (the CRA in Canada). The tax authority then shares that information with the IRS. As the IRS analyzes the data it receives from foreign financial institutions, it will become more difficult for U.S. citizens living outside the U.S. to avoid their American tax obligations.

Canadian taxpayers must check a box on page 2 of their tax returns disclosing whether they owned foreign property at any time during the tax year worth more than CAN\$100,000 in total. If the taxpayer checks the "yes" box, they must file a Form T1135 with their return, disclosing the existence, approximate value, and location of the foreign property. The foreign property reporting requirement applies even if the foreign assets generate no income, and is in addition to a taxpayer's obligation to report all income, including foreign income, on their tax return. Failing to report foreign property and income on a tax return and failing to file a Form T1135 may result in penalties, even if the failure is inadvertent.⁴

Tax treaties

Among the many purposes of a tax treaty, two are to harmonize international taxation and protect taxpayers of each country against double taxation. But tax treaties can also assist tax collectors. For example, Article XXVI-A of the Canada – U.S. Convention gives the tax authorities in each country the right to request assistance from their counterparts in the other country. Canada therefore agrees to collect U.S. taxes from Canadians as if the U.S. taxes were owed to the CRA, and the United States pledges the same assistance to Canada. This provision applies only in cases where the taxpayer has not voluntarily paid what they owe and has exhausted all avenues available to them to dispute their tax liability. Article XXVII is entitled "Exchange of Information", and allows each country's taxing authorities to share information with their counterparts, subject to having to respect the privacy of information received from the other country in the same way that they would treat their own information.

Voluntary disclosure and amnesties

How can you help a client who has unknowingly or deliberately violated another country's tax laws and wants to rectify the situation? Both the IRS and the CRA allow taxpayers to voluntarily disclose information that they should have reported but, for whatever reason, did not.⁵ The "carrot" in each country's voluntary disclosure practice is the discretion to not recommend prosecution for tax evasion if the taxpayer approaches the tax authority before the tax authority finds out about him or her. Generally, a taxpayer will still owe any tax they should have paid, plus interest and civil penalties (like late filing fees), but may avoid criminal prosecution for tax evasion (again, subject to the taxing authority's discretion). The "stick" in the program is that if the taxing authority finds out about the taxpayer's transgression before they contact them, the possibility of voluntary disclosure is gone, and the taxpayer may be liable for criminal prosecution for tax evasion (and will still have to pay the tax, interest and civil penalties).

In addition to their voluntary disclosure practices, the tax authorities also periodically offer amnesties for those who have not filed required information. An amnesty is different from voluntary disclosure in that no penalties of any kind (criminal or civil) will be assessed against those entitled to the amnesty and who comply with its terms. In 2009 the IRS offered an amnesty for those who have been late in filing a Foreign Bank Account Report (FBAR). Everyone subject to U.S. tax laws, and owning (or having signing authority over) a foreign account worth over US\$10,000, must file a report disclosing the existence of the account, even if the account generates no taxable income. A foreign bank account is broadly defined,

⁴ As of the 2013 tax year Form T1135 has been amended to require more information. According to the CRA, among the new information requirements are the following: a requirement to name the specific foreign institution or entity holding funds outside of Canada, the specific country to which the property relates, and the income generated from the property. <http://www.cra-arc.gc.ca/gncy/bdgt/2013/txvsn3-eng.html>

⁵ This section of the article discusses the IRS' voluntary disclosure practice which applies generally to taxpayers who wish to disclose previous nonconformity with U.S. tax laws and bring themselves back into conformity with those laws. The IRS also had a specific "Voluntary Disclosure Program" targeted at U.S. taxpayers with offshore accounts who had not reported taxable income generated from those accounts. Since 2009 the IRS has offered other voluntary disclosure programs and initiatives, in 2011, 2012 and 2014. There is no guarantee that any program will not end or be modified at a future point.

and may include non-bank accounts. Although there are potentially severe penalties for not filing an FBAR, fewer people were filing than the U.S. Treasury Department believed should have been filing. In general terms, the amnesty program applied if you had reported all your income from your foreign accounts, had paid all tax owing on that income, but had not filed an FBAR. Under the amnesty you could file your delinquent FBARs (together with copies of your tax returns) by September 23, 2009, and avoid late-filing penalties.

If a client believes that they are in non-compliance with U.S. or Canadian tax law, but may be able to benefit from a voluntary disclosure or amnesty arrangement, encourage them to speak with their professional tax advisor about how to handle the situation, and act quickly. There are often limits to amnesty programs that restrict their application to a select few, there may be deadlines within which to act, and the longer a client delays action, the more likely it is that the tax authority will discover the problem on their own. Further, making a voluntary disclosure may require the client to disclose more information than they may want to, or more than their particular transgression covers. The client's voluntary disclosure may also impact other taxpayers, like co-owners in a business. Making a voluntary disclosure or taking advantage of an amnesty could also lead to an audit of previously filed tax returns. Still, the advantages of "coming clean" usually outweigh the perceived (and probably illusory) advantages of laying low and hoping to not be caught.

Consequences to advisors of clients who break the law

Both the U.S. and Canada have strict penalties for tax evasion that affect not only the individual, but also potentially their advisors. Advisors may be penalized for advice that is later determined to have assisted in tax evasion. Those penalties include fines and possible jail terms. Depending on the circumstances, there also could be issues with licensing and regulatory bodies that govern the advisor. In certain circumstances, Canadian tax laws may also hold the advisor personally liable for taxes owed by the client.

Advising clients

- It is reasonable to assume that the IRS and CRA can identify cases of non-compliance with their tax laws. Be alert to domestic and foreign tax issues raised when doing Canadian-based planning.
- Clients rely on you for sound, practical advice. Dissuade them from "forgetting" to comply with U.S. tax laws or "not bothering" because of the extra effort required. Make sure that they understand the fallacy in the oft-repeated saying, "What they don't know won't hurt them". Wishful thinking is never a substitute for accurate information and professional advice.
- If a client believes that they may have a problem with the IRS or CRA, encourage them to speak with a professional tax advisor on steps they may need to take to resolve the problem.

Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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