

NEW IRS COMPLIANCE: INTERNATIONAL FOCUS

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The IRS's Large Business and International Division recently announced six new enforcement campaigns. Periodically, the IRS has attempted to best use its institutional knowledge and coalesce its limited resources around issues with heightened compliance risks through specific enforcement campaigns.

Of the six recent campaigns, five focus on international taxation that may affect Canadian residents, citizens, and companies.

- 1. Foreign trust reporting.** This campaign focuses on the enforcement of filing requirements related to foreign trusts. Form 3520 reports the ownership of, or transactions with, a foreign trust by a US person and must be filed when a US person (a) is the foreign trust's owner under Code sections 671-679; (b) receives a distribution from a foreign trust; (c) engages in certain lending transactions with a foreign trust; or (d) receives certain large gifts from a non-resident alien (NRA) individual, trust, or foreign corporation or partnership. Form 3520-a must be filed annually by any foreign trust that has at least one US owner, except RRSPs and RRIFs. The US owner is responsible for ensuring that the foreign trust files form 3520-a and distributes required annual statements to US beneficiaries. The IRS campaign will seek to ensure compliance with these filing requirements by examining (auditing) and assessing penalties against late-filed and incomplete returns. Penalties imposed on the US owner for failure to file or to provide complete information can reach the greater of US \$20,000 and 5 percent of the gross value of the trust considered owned by the US person.
- 2. US-source income withholding compliance.** This campaign highlights increased compliance efforts with regard to the filing of forms 1042 and 1042-s, which must be filed by any withholding agent that pays US-source income to foreign persons. Form 1042 reports tax withheld on certain income of foreign persons, including non-residents and foreign partnerships, corporations, estates, and trusts. Form 1042-s reports income and withholding amounts and deferred compensation, distributions from trusts to expatriates, distributions by publicly traded trusts and qualified investment entities, and distributions of effectively connected income by publicly traded partnerships. A Canadian resident with US-source investment income may have US withholding tax imposed at source,

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and thus a form 1042 must be filed reporting the income and withholding to the IRS. The Canadian resident may be required to file a US form 1040NR to report the income and pay the associated tax if the appropriate source withholding is not made. The Large Business and International Division seeks to increase compliance by withholding agents with these withholding, deposit, and reporting requirements, and it has identified increased examination as an effective treatment.

3. **Non-US taxpayer and itemized deductions.** This campaign focuses on ensuring that an NRA taxpayer complies with the law and regulations when claiming schedule A itemized deductions on his or her income tax return (form 1040NR). Generally, expenses and losses may be claimed as schedule A deductions only if allocated and apportioned to income effectively connected with a US trade or business; those related to exempt income or non-effectively connected income are generally non-deductible. Permissible deductions include state and local income taxes paid, gifts to US charities, certain casualty or theft losses (over 10 percent of adjusted gross income [AGI]), ordinary and necessary unreimbursed job expenses, tax preparation fees, and other expenses related to the generation of income. Familiarity with the nuanced rules regarding the availability and limitation of certain deductions is important: for example, miscellaneous deductions are allowed only to the extent that they exceed 2 percent of a taxpayer's AGI. The announcement specifically notes that attention will be paid to both non-us taxpayers who take deductions for which they are not eligible and non-US taxpayers who take deductions for which they are eligible but have failed to substantiate with supporting documentation. The Tax Cuts and Jobs Act (enacted late 2017) included sweeping changes for NRA taxpayers, especially regarding the permissibility of certain schedule A itemized deductions: for example, the deduction for state and local taxes is now capped at US \$10,000; the personal exemption is eliminated; state taxes paid in prior years are no longer deductible; and miscellaneous deductions, such as unreimbursed employee expenses and tax preparation fees, are largely eliminated. In light of these changes and because the IRS has now identified schedule A deductions as an increased enforcement priority, a Canadian taxpayer filing a US tax return should—before claiming a deduction—confirm eligibility and ensure substantiating documentation.
4. **Canada-US treaty compliance.** The IRS increased its focus on an NRA's compliance with treaty exemptions claimed with regard to effectively connected income and fixed, determinable, annual, periodical income (FDAP). The announcement states that non-compliance may result from failing to understand treaty provisions, providing incorrect or incomplete forms to withholding agents, or relying on incorrect advice from withholding agents with regard to treaty benefits and exempt income. The Canada-us treaty generally seeks to provide relief from double taxation by both tax authorities. Although the treaty is wide-ranging in scope, a taxpayer claiming a treaty benefit may be required to file IRS form 8833 to disclose its position. A Canadian taxpayer should confirm both that the treaty applies to his or her specific situation and that any required form 8833 is filed in a timely manner.
5. **Impermissible tax credits for non-US taxpayers.** This campaign signals heightened focus on certain tax credits claimed by non-us taxpayers. Through educational outreach and traditional examinations, the IRS will focus on ensuring that a non-us taxpayer claiming tax credits is eligible to claim such credits and that such claims are supported by documentation. The IRS announcement specifically identifies taxpayers who (a) have no qualifying earned income, (b) claim dependant-related credits without qualifying dependants, or (c) claim education credits (available only to a US person) by erroneously filing a form 1040.

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These enforcement campaigns provide insight into the IRS's future resource allocation and enforcement priorities and also issue a warning to non-compliant taxpayers. The campaigns launched by the Large Business and International Division focus on international tax, especially non-resident taxpayers and information-filing requirements. Canadians and other non-US taxpayers should be aware of their US tax reporting requirements and ensure that their returns are accurate and timely.