IRS SCRUTINY INTENSIFIES

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Many non-US residents are unaware of their actual or potential US tax liabilities. A US-citizen Canadian resident remains liable for US income tax on worldwide income and for US gift, estate, and generation-skipping transfer tax on worldwide assets. And a Canadian-citizen Canadian resident who owns US-situs property may be exposed to US income, gift, or estate tax. Clients should be advised that regardless of the likelihood of detection, the US tax obligation exists. Recent developments in information sharing increase these taxpayers' transparency.

Homeland Security and the IRS apparently now share information. A border crossing guard may have information readily available in his or her booth computer concerning a traveller's unpaid US tax liabilities and may bar the traveller's entry into the United States. In addition, anecdotal evidence indicates that Homeland Security agents may be acquiring US tax sophistication and, for example, a border guard may ask a traveller with a green card or a non-resident US citizen whether he or she has been filing US tax returns. Even if a non-US passport is used at the US point of entry, most countries' passports list the place of birth, allowing Homeland Security to easily identify a traveller who is a US citizen by reason of his or her birth in the United States.

It has been known for years that the CRA and the IRS exchange large quantities of information, and now US and Canadian governmental agencies engage in other information-sharing initiatives, such as the Joint International Tax Shelter Information Center formed by the tax administrations of the United Kingdom, the United States, Australia, and Canada. The US tax system applicable to US taxpayers with assets outside the United States is very expansive, and affected taxpayers are continually targeted by promoters of complex and significantly aggressive strategies--which may be tax shelters for US tax purposes or simply fraudulent--that purport to reduce or eliminate US tax exposure for foreign assets. By entering into cooperative governmental initiatives, the United States seeks to discover whether US taxpayer activity abroad is depriving the US Treasury of its rightful due.

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Perhaps the most common situation, and the most troubling for an adviser, is that of the US-citizen Canadian resident--often a person who acquired citizenship by being born in the United States and who lived there only briefly--who has not been filing US income tax returns. He or she may have never filed a US tax return and may be unaware of the obligation to do so. But even if the failure to file is not detected during his or her lifetime, the estate's administrators and heirs face difficult issues because the US income tax liability passes to the estate; there may also be US gift and estate tax exposure and a return to file. The administrators and the beneficiaries face the dilemma of whether to file a US estate tax return, and whether to come clean to the IRS over the failure to file income tax returns or keep silent and hope the IRS does not learn of the situation. Even if the estate administrators decide to take the position that the decedent relinquished US citizenship at some point, a US estate tax return must be filed if, for example, the decedent died owning US stocks or US real property. The non-resident estate tax return (form 706-NA) requires disclosure of the place where the decedent was born and may thus trigger scrutiny.

Experience is revealing that it is becoming much easier for the IRS to discover neglected filing and tax liability obligations. And a US citizen who ignores the issues before death leaves the estate's administrators and heirs in an extremely difficult position. Not only can the IRS seek to collect against the decedent's US assets, but the administrators and heirs are exposed to transferee liability: the IRS can proceed relatively easily to collect against any US-situs assets they may hold. Even Canadian assets may not be difficult to find or to proceed against, given the Canada-US treaty mechanisms for the CRA's sharing of information and assistance in collections.

Many non-US-citizen Canadians are surprised to find that their US assets carry US tax exposure. For example, a Canadian who owns stock in a US corporation--even stock held in "street name" at a brokerage firm--holds a US-situs asset and is exposed to US estate tax. (To add to the confusion, there is no US gift tax exposure on an inter vivos transfer of the shares to a family member.) A Canadian spouse who purchases US real property as "husband and wife," or otherwise as a joint tenant with right of survivorship, may expect to receive US estate tax deferral until the death of the survivor, as in Canada. However, this is generally not the case in the absence of significant planning (such as the creation of a qualified domestic trust), and often only the surviving spouse's death reveals the US estate tax considerations related to the other spouse's death.

Moreover, many US states have even more sophisticated systems than the IRS to discover information about taxpayers who may be exposed to state income or other taxes. For example, if a Canadian citizen and resident dies owning New York state real estate, it may be impossible to transfer title without alerting the New York State Department of Taxation and Finance to the state estate tax exposure. Moreover, New York income tax may be owing if the property was rented during the decedent's lifetime and no related state tax returns were filed. The US states tend to be even more aggressive than the IRS in finding--and pursuing--these tax liabilities.