Elena can be reached at 416-595-2965 or ehoffstein@millerthomson.com.

DON'T FORGET ABOUT INTERNATIONAL INFORMATION RETURNS – IT COULD COST YOU (DEARLY)!

By Paul Bercovici, LL.B., Principal, Marks Paneth LLP

INTRODUCTION

In recent years, the IRS had placed significant emphasis on offshore issues, including taxpayers' obligations to file certain international information returns. As a general rule, certain US persons are required to report ownership interests in foreign entities such as controlled foreign partnerships, foreign corporations and foreign entities that are treated as disregarded entities for US federal income tax purposes. In addition, US persons are generally required to report ownership interests in foreign financial accounts and transactions or dealings with certain foreign trusts and estates. Failure to timely file complete and accurate international information returns can result, in certain cases, in the imposition of significant penalties.

Moreover, in recent years, the IRS has come to view such penalties as "low-hanging fruit", which they are more than happy to harvest. Anecdotal evidence suggests that the IRS is most likely to issue penalty notices when a taxpayer ceases to file a particular international information return which they have filed in the past, despite the fact that the IRS could not possibly know whether the taxpayer is still required to file the particular return in question.

Historically, significant numbers of US citizens have lived in Canada. In addition, many Canadians and others who hold valid "green cards"[1] also live in Canada. Recall that for US federal income tax purposes, green card holders are treated the same as US citizens. That is, green card holders are subject to US federal income tax on their worldwide income and are generally obligated to file annual US federal income tax returns. Many such individuals may not be aware that they are required to include certain of the above-noted international information returns with their annual US federal income tax returns and that failure to do so may result in the imposition of significant penalties.

The following article considers the filing obligations and penalty implications associated with the failure to timely file complete and accurate versions of some of the more common international information returns required to be filed by natural persons. Many of the filing requirements that apply to natural persons also apply to domestic entities such as corporations, partnerships and trusts. However, for the purposes of this article we will consider only the obligations of natural persons to file these returns. For the remainder of this article, the term "US person" includes US citizens, lawful permanent residents of the US (i.e., green card holders) and individuals who are not citizens of the US or green card holders but who do meet the "substantial presence test"[2] for a particular tax year.

FORM 8865

Return of US Persons with Respect to Certain Foreign Partnerships

IRS Form 8865 is used by US persons to report the information required to be reported under Internal Revenue Code ("IRC") Sections 6038[3], 6038B[4] and 6046A[5].

A US person who meets one or more of the descriptions of categories of filers set out below is required to provide the information set out in the chart entitled "Filing Requirements for Categories of Filers" in the Instructions for Form 8865. The filing requirements can be quite onerous and may include items such as a balance sheet, income statement, reconciliation of income or loss per books with income or loss per return and an analysis of partners' capital accounts. Form 8865 is to be attached to the taxpayer's federal income tax return and is due by the due date (including extensions) for the filing of the taxpayer's return.

Categories of Filers

Category 1: A category 1 filer is a US person who "controlled" the "foreign partnership"[6] at any time during the year. For these purposes, the term "controlled" means owning, or being attributed, directly or indirectly, at least 50% of the capital interest, 50% of the profits interest, or 50% of the deductions or losses of the foreign partnership.

Category 2: A category 2 filer is a US person who owned at least 10% of the capital or profits interest in the partnership, or who was allocated at least 10% of the losses and deductions of the partnership (referred to as a "10% partner") and the partnership is controlled by one or more US persons each of whom is a 10% partner.

No person is required to file as a category 2 filer if a foreign partnership had a category 1 filer at any time during the tax year.

Category 3: A category 3 filer is a US person who contributed property during the person's tax year to the foreign partnership in exchange for an interest in the partnership.

Category 4: A category 4 filer is a US person who acquired or disposed of a "significant interest"[7] in a foreign partnership, or whose direct proportionate interest in the partnership changed.

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1 Individuals who hold green cards are entitled to live permanently in the US. Such individuals are technically known as "lawful permanent residents" of the US.

2 In determining whether or not an individual meets the substantial presence test for a particular tax year, the individual must be physically present in the US on at least 31 days during the current year, and 183 days during the three-year period that includes the current tax year, the first preceding tax year and the second preceding tax year, counting: all of the days that the individual was physically present in the US in the current tax year, 1/3 of the days that the individual was physically present in the US in the first preceding tax year and 1/6 of the days that the individual was physically present in the US in the second preceding tax year.

3 Information Reporting with Respect to Certain Foreign Corporations and Partnerships.

4 Notice of Certain Transfers to Foreign Persons.

5 Returns as to Interests in Foreign Partnerships.

6 The term foreign partnership is defined in IRC Section 7701(a)(5) to mean a partnership which is not "domestic". IRC Section 7701(a)(4) defines a domestic partnership as a partnership which was created or organized in the US or under the law of the US or of any state.

7 The rules for determining what constitutes a significant interest can be quite complex. For more information as to what constitutes a significant interest, see the Instructions for Form 8865.

Application of Constructive Ownership Rules

It is extremely important to note that certain "constructive ownership" rules must be applied in determining whether a particular taxpayer meets the definition of filer for a particular category. These constructive ownership rules are also sometimes referred to as "attribution rules". In general, the constructive ownership rules will attribute ownership interests in controlled foreign partnerships which are held by certain family members and certain types of entities to a US person. It is beyond the scope of this article to delve into the constructive ownership rules in detail. However, it is fair to say that the application of the constructive ownership rules can, in certain circumstances, be extremely complex. Therefore, it is essential that preparers of Form 8865 be aware of the potential application of the attribution rules in preparing the form for their clients.

FORM 5471

Information Return of US Persons With Respect to Certain Foreign Corporations

Form 5471 is used by US persons who are officers, directors and/or shareholders of certain foreign corporations to satisfy the reporting requirements of IRC Sections 6038[8] and 6046,[9] and the related regulations. For these purposes, the term "foreign corporation" means a corporation that was not created or organized in the US or under the laws of the US or of any state.[10] US persons who meet one or more of the descriptions of categories of filers set out below are required to provide the information set out in the chart entitled "Filing Requirements for Categories of Filers" in the Instructions for Form 5471. As a general rule, the ownership percentage threshold for having to file Form 5471 is 10%. There is a summary filing procedure for foreign corporations that meet the conditions for filing as a "dormant foreign corporation".[11]

As with Form 8865, the Form 5471 filing requirements can be quite onerous and may include items such as a balance sheet, income statement, reconciliation of accumulated earnings and profits ("E&P") and information regarding the global intangible low-taxed income ("GILTI") of the foreign corporation. Form 5471 is to be attached to the taxpayer's federal income tax return and is due by the due date (including extensions) for the taxpayer's return.

Categories of Filers

Category 1: For the period 2004 to 2017, this category of filer had been repealed. For the 2018 and subsequent tax years, this category applies to a "US shareholder" of a foreign corporation that is a "specified foreign corporation" ("SFC").

For these purposes an SFC is:

1. A "controlled foreign corporation" ("CFC"):[12] or
2. Any foreign corporation with respect to which one or more domestic corporations is a US shareholder

Category 2: A category 2 filer is a US person who is an officer or director of a foreign corporation in which a US person (not necessarily the officer or director) acquires:

1. Stock which meets the 10% stock ownership requirement with respect to the foreign corporation; or
2. An additional 10% or more (in value or voting power) of the outstanding stock of the foreign corporation

Category 3: A category 3 filer is a US person who acquires or disposes of amounts of stock in the foreign corporation which causes them to exceed or drop below the 10% stock ownership threshold for having to file Form 5471.

Category 4: The category 4 filing requirement applies to a US person who had "control" of a foreign corporation during the annual accounting period of the foreign corporation

For the purposes of category 4, the term control means ownership of stock possessing:

1. More than 50% of the total combined voting power of all classes of stock of the foreign corporation entitled to vote; or
2. More than 50% of the total value of shares of all classes of stock of the foreign corporation

Category 5: For the 2017 and prior tax years, the category 5 filing requirement applied to a US shareholder who owned (directly, indirectly or constructively) 10% or more of the total combined voting power of all classes of stock of a CFC. For the 2018 and subsequent tax years, the Category 5 filing requirement applies to a US shareholder who owns (directly, indirectly or constructively) 10% or more of the total combined voting power of all classes of voting stock of a CFC or 10% or more of the total combined voting power or value of shares of all classes of stock of the CFC at any time during any tax year of the CFC and who owned the stock on the last day in that year on which it was a CFC.

Application of Constructive Ownership Rules

As with Form 8865, certain constructive ownership rules apply in determining whether a particular US person fits within the definition of a particular category of filer for the purposes of Form 5471. In fact, different categories of filers of Form 5471 may be subject to different attribution rules.[13] The comments regarding the application of the constructive ownership rules vis-à-vis the obligation to file Form 8865 which appear earlier in this article also generally apply regarding the obligation to file Form 5471.

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8 See footnote 3.

9 Returns as to Organization or Reorganization of Foreign Corporations and as to Acquisitions of Their Stock.

10 IRC Section 7701(a)(4) and (5).

11 See Rev. Proc. 92-70.

12 The term controlled foreign corporation is defined in IRC Section 957(a) as any foreign corporation if more than 50% of the stock (by vote or value) is owned by "US shareholders". For these purposes the term US shareholder means a US person who owns, directly, indirectly or constructively, 10% or more of the total voting power or the total value of all classes of stock of the CFC. See also Reg. 1.957-1(a).

13 For example, for category 2 and 3 purposes there is attribution between siblings but there is no such attribution for the purposes of categories 4 and 5.

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FORM 8858

Information Return of US Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)

Form 8858 is used by US persons who are owners of a foreign disregarded entity ("FDE") or a foreign branch ("FB") to satisfy the reporting requirements of IRC Sections 6011,[14] 6012,[15] 6031,[16] 6038,[17] and the related regulations.

A US person that operates an FB as a "tax owner" of an FDE or that owns certain interests in tax owners of FDEs is required to file Form 8858 and Schedule M.[18] The term FB is defined in Treas. Reg. 1.367(a)-6T(g) as "an integral business operation carried on by a US person outside the United States".[19] An FDE is an entity that is not created or organized in the US and that is disregarded as an entity separate from its owner for US federal income tax purposes. The tax owner of an FDE is the person that is treated as owning the assets and liabilities of the FDE for the purposes of US income tax law. In most cases, FDEs are created as a result of the owner of the foreign entity making an entity classification election (commonly known as a "check-the-box" election) on IRS Form 8832[20] to treat the foreign entity as an FDE for US federal income tax purposes.

The information required to be reported on Form 8858 includes an income statement, balance sheet, IRC Section 987 gain or loss information and answers to certain complex questions regarding the operations of the FDE or FB.

FORM 8938

Statement of Specified Foreign Financial Assets

An individual is required to file Form 8938 if:

- they are a "specified individual";
- they have an "interest" in "specified foreign financial assets"; and
- the value of those assets is more than the applicable reporting threshold

US citizens meet the definition of specified individual for the purposes of determining whether an individual is required to file Form 8938. An individual is considered to have an "interest" in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the asset are or would be required to be reported, included, or otherwise reflected on their income tax return.

For the purposes of Form 8938, the term "specified foreign financial asset" includes financial accounts maintained by a foreign financial institution, stock or securities issued by someone that is not a US person, any interest in a foreign entity and any financial instrument or contract that has an issuer or counterparty that is not a US person.[21] The reporting threshold for a particular taxpayer depends upon their federal tax filing status and whether they live inside or outside the US.[22]

It is important to note that where a taxpayer's ownership interest in a foreign entity or in a foreign trust is reported on Forms 5471, 8865, 3520, 3520-A[23] or 8621,[24] the taxpayer is permitted to report such ownership or trust interests in Part IV of Form 8938 (Excepted Specified Foreign Financial Assets) and does not have to also report the ownership or trust interest in Part VI (Detailed Information for Each "Other Foreign Asset" Included in the Part II Summary) of Form 8938.

FORM 3520

Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts

US persons who engaged in one or more of the following transactions in a particular tax year are required to file Form 3520:

- Transferred, directly or indirectly, money or other property to a foreign trust;
- Held an outstanding obligation of a related foreign trust;
- Was the executor of the estate of a US decedent;
- Was the "owner"[25] of all or any portion of a foreign trust;
- Received a distribution from a foreign trust;
- Was the US owner or beneficiary of a foreign trust which made a loan to the US person, or to a person to whom the US person was related, of cash or marketable securities;
- Was the US owner or beneficiary of a foreign trust which provided the US person, or a person to whom the US person was related, with the uncompensated use of trust property; and
- Received certain gifts or bequests from a foreign person

In my personal experience, some of the most outrageous examples of IRS overreach in seeking to assert penalty claims involve claims

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14 General Requirement of Return, Statement, or List.

15 Persons Required to Make Returns of Income.

16 Return of Partnership Income.

17 See footnote 3.

18 Transactions Between Foreign Disregarded Entity (FDE) or Foreign Branch (FB) and the Filer or Other Related Entities.

19 Treas. Reg. 1.367(a)-6T(g) goes on to state that "[w]hether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States."

20 Entity Classification Election.

21 This is only a small sample of the types of assets which are considered to be specified foreign financial assets for the purposes of Form 8938 reporting. Reference should be had to the Instructions for Form 8938 and the IRS release entitled "Comparison of Form 8938 and FBAR Requirements" for a more complete listing of the types of assets which the IRS considers to be specified foreign financial assets. This release was last reviewed or updated on December 20, 2019.

22 For example, married taxpayers who live in the US and who file a joint return satisfy the reporting threshold only if the total value of their specified foreign financial assets is more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.

23 Annual Information Return of Foreign Trust With a U.S. Owner.

24 Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

25 The owner of a foreign trust is the person that is treated as owning any of the assets of a foreign trust under the grantor trust rules.

that an individual failed to file Form 3520 when they were required to do so. For example, I am aware of a case where the IRS asserted total penalties of $160,000 where a taxpayer failed to report an interest in a Canadian Registered Education Savings Plan ("RESP") that had a balance of just over $5,000.[26] The IRS's position was based on the dubious claim that the RESP constituted a "foreign trust" for US federal income tax purposes. The taxpayer's attempts to have the penalties abated turned into a real-life nightmare for which they were ultimately able to obtain only partial relief.

APPLICATION OF PENALTIES FOR FAILURE TO TIMELY FILE COMPLETE AND ACCURATE INTERNATIONAL INFORMATION RETURNS

As a general rule, for all of the IRS forms referred to above, significant monetary penalties can be imposed for failure to timely file complete and accurate versions of the particular form. In addition, in certain circumstances, other types of penalties, such as the reduction of otherwise available foreign tax credits, the extension of the otherwise applicable statute of limitations and certain criminal penalties, may also be imposed. A detailed discussion regarding the application of penalties to particular categories and types of filers is beyond the scope of this article. Suffice to say that the analysis of potentially applicable penalties in certain circumstances can by painstaking and laborious.

SEEKING ABATEMENT OF PENALTIES BY ASSERTING REASONABLE CAUSE

Many of the penalties referred to above can be abated or eliminated where the taxpayer is able to demonstrate that their failure to file a particular international information return was due to "reasonable cause".[27] It should be noted that for different types of penalties, the concept of reasonable cause may also be slightly different. The concept of reasonable cause has largely been developed by the courts and is very fact specific.

As a general rule, a taxpayer is considered to have reasonable cause when his or her conduct justifies the non-assertion of penalties. In order to demonstrate reasonable cause, a taxpayer is required to make an affirmative showing of facts supporting reasonable cause. A taxpayer will generally be found to have reasonable cause when he or she can demonstrate that they exercised "*ordinary business care and prudence*" in determining their tax filing obligations, but nonetheless were unable to comply with those obligations. Any reason that demonstrates that the taxpayer exercised ordinary business care and prudence is supposed to be considered by the IRS in making their determination. It is well settled that the ordinary business care and prudence standard requires taxpayers to make reasonable efforts to determine their tax obligations.

Whether a taxpayer had reasonable cause for a particular failure is to be determined in light of the specific facts and circumstances surrounding the alleged failure of a taxpayer to fulfill their tax filing obligations. Section 20.1.1.3.2.(3)a of the Internal Revenue Manual (the "IRM")[28] provides that,

> For those penalties where reasonable cause can be considered, <u>any</u> reason which establishes that the taxpayer exercised ordinary business care and prudence, but nevertheless was unable to comply with a prescribed duty within the prescribed time, will be considered.

In addition, Section 20.1.1.3.2.(3).c of the IRM provides that,

> An acceptable explanation is <u>not</u> (emphasis added) limited to those given in IRM section 20.1. Penalty relief may be warranted based on an "other acceptable explanation," provided the taxpayer exercised ordinary business care and prudence but was nevertheless unable to comply within the prescribed time.

The determination of what constitutes reasonable cause has been the subject of numerous court decisions over the years. Some of the more common reasons or explanations that have been recognized by the courts over the years as constituting reasonable cause include:

- Reasonable reliance on a competent tax advisor;
- Death, serious illness or unavoidable absence;
- Unavailability of records; and
- The receipt of incorrect advice from the IRS

As noted earlier, convincing the IRS that a particular taxpayer had reasonable cause for his or her failure to file a complete and accurate international information return can be an extremely difficult exercise. Nonetheless, in appropriate circumstances, the IRS has been willing to accept that a taxpayer had reasonable cause for their failure to file a complete and accurate international information return and have agreed to waive or abate otherwise applicable penalties.

FinCEN FORM 114

Report of Foreign Bank and Financial Accounts

Unlike the IRS forms referred to above, the FinCEN 114 form (commonly known as and hereinafter referred to as the "FBAR") is a Treasury Department form and not an IRS form. Compliance issues pertaining to the FBAR are, however, administered by the IRS. The FBAR has been around in one form or another for decades, but (much like the IRS forms referred to above) has become a much more significant point of compliance emphasis in the recent past. FBARs are filed through the Financial Crimes Enforcement Network's BSA[29] e-filing system.

As a general rule, a "United States person" is required to file an FBAR if:

i. They had a "financial interest in" or "signature authority" over "foreign financial accounts"; and

ii. The aggregate value of the "foreign financial accounts" exceeded $10,000 at any time during the calendar year.

[26] The penalty amount asserted by the IRS was calculated as $10,000 per year for eight years, for both the individual who established the RESP and the beneficiary of the RESP.

[27] The abatement of certain penalties, for example the penalties imposed in connection with the failure to file complete and accurate Forms 3520, requires the taxpayer to demonstrate that their failure to comply was due to reasonable cause <u>and</u> not due to willful neglect. For these purposes, the term "willful neglect" has been interpreted to mean a conscious, intentional failure or reckless indifference.

[28] The Internal Revenue Manual is an official compendium of internal guidelines for IRS personnel.

[29] Bank Secrecy Act.

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For FBAR purposes, the term "United States person" includes US citizens, US residents and domestic entities. For FBAR purposes, the term "financial account" includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). The term "foreign financial account" means a financial account located outside of the US.[30] The term "signature authority" means the authority of an individual (alone or in conjunction with another individual) to control the disposition of assets held in a foreign financial account by direct communication (whether in writing or otherwise) to the bank or other financial institution that maintains the financial account.

A United States person is deemed to have a financial interest in a foreign financial account for which the owner of record or holder of legal title is a partnership in which the United States person owns directly or indirectly:

i. An interest in more than 50% of the partnership's profits (e.g., distributive share of partnership income taking into account any special allocation agreement); or

ii. An interest in more than 50% of the partnership capital.

Similarly, a United States person is deemed to have a financial interest in a foreign financial account for which the owner of record or holder of legal title is a corporation in which the United States person owns directly or indirectly:

i. More than 50% of the total value of all shares of stock; or

ii. More than 50% of the voting power of all shares of stock[31]

Potential Penalties for Failure to Timely File an FBAR

As noted earlier, the FBAR is a form that is issued by the Treasury Department and not by the IRS. As a result, the rules regarding the application of and potential abatement of penalties are different than the rules applicable to the IRS international information returns referred to earlier in this article.

The penalty for "non-willful" failure to timely file an FBAR is $10,000 per violation.[32] However, where the failure to timely file an FBAR was "non-willful" and the taxpayer is able to establish reasonable cause, no penalty for failure to timely file an FBAR is to be imposed.[33] For FBAR penalty purposes, in very general terms, the term reasonable cause has been interpreted to mean that the taxpayer exercised "ordinary business care and prudence" in attempting to ascertain and fulfill their FBAR filing requirements.

Where the failure to timely file an FBAR was "willful", the penalty is equal to the greater of $100,000 or 50% of the balance in the account at the time of the violation.[34] Willful violations may also subject the taxpayer to criminal penalties. Per IRM Section 4.26.16.6.5.1, the test for willfulness is whether there was a "voluntary, intentional violation of a known legal duty". The burden of establishing willfulness is on the Service.[35] Per IRM Section 4.26.16.6.5.1(4), "willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements." In the FBAR context, the person only need know that a reporting requirement exists. If a person has such knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR. Per IRM Section 4.26.16.6.5.1,(5), under the concept of "willful blindness," willfulness is attributed to a person who made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements.

The IRM also provides that the mere fact that a person checked the wrong box, or no box, on Schedule B[36] of IRS Form 1040 is not sufficient, in itself, to establish that the FBAR violation was attributable to willful blindness.[37]

Penalty Mitigation

IRM Section 4.26.16.6.6.(1) provides that the statutory penalty computation provides a ceiling on the FBAR penalty but that the actual amount of the penalty is left to the discretion of the examiner. Per IRM Section 4.26.16.6.6.1(1), for most FBAR cases, if the IRS determines that a person has met four threshold conditions, then that person may be subject to less than the otherwise maximum FBAR penalty depending on the amounts in the accounts.

The four threshold conditions are:

A. The person has no history of criminal tax or *Bank Secrecy Act* ("BSA") convictions for the preceding 10 years, as well as no history of past FBAR penalty assessments;

B. No money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose;

C. The person cooperated during the examination (i.e., the IRS did not have to resort to a summons to obtain non-privileged information; the taxpayer responded to reasonable requests for documents, meetings, and interviews; and the taxpayer back-filed correct reports); and

D. The IRS did not sustain a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account.

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30 The BSA Electronic Filing Requirements For Report of Foreign Bank and Financial Accounts (FinCEN Form 114) provide that an account maintained with a branch of a US bank that is physically located outside of the US is a foreign financial account and that an account maintained with a branch of a foreign bank that is physically located in the US is not a foreign financial account.

31 Similar rules also apply to trusts in which a United States person has a greater than 50% present beneficial interest in the assets or income of the trust.

32 31 U.S.C. Section 5321(a)(5)(B)(i). Per IRM 4.26.16.6.4.1(1), in most cases, examiners will recommend one penalty per open year, regardless of the number of unreported foreign accounts. However, for multiple years with nonwillful violations, examiners may determine that asserting nonwillful penalties for each year is not warranted. In such cases, examiners may assert a single penalty, not to exceed $10,000 for one (emphasis added) year only. See IRM 4.26.16.6.4.1(2)

33 IRM 4.26.16.4.11(4).

34 31 U.S.C. Section 5321(a)(5)(C)(i)..

35 IRM 4.26.16.6.5.1(3).

36 Schedule B of Form 1040 is entitled Interest and Ordinary Dividends. The question referred to in the IRM in the 2019 version of Schedule B is "[A]t any time during 2019, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country?

37 IRM Section 4.26.16.6.5.1(5)

CONCLUSION

In recent years, the IRS has placed significantly increased emphasis on international tax compliance issues. Among the points of emphasis has been IRS scrutiny of a taxpayer's obligation to file certain international information returns and FBARs. The reporting requirements associated with the filing of international information returns and FBARs can be quite onerous. However, failure to timely file complete and accurate international information returns and FBARs may result in the imposition of very significant penalties. In addition, the IRS is generally not particularly receptive to taxpayers' assertions of reasonable cause in an attempt to have such penalties abated or reduced. As a result, it behooves taxpayers who are obligated to file international information returns and FBARs to ensure that they are complete and accurate and that they are filed on a timely basis.

Paul Bercovici, LL.B., is the Principal of Marks Paneth LLP, New York, New York.

Paul can be reached at PBercovici@markspaneth.com.

NEW TIGHTENED CMHC LENDING RULES FOR HOME BUYERS

By Tina Tehranchian, MA, CFP®, CLU®, CHFC®, MFA-P™ (Philanthropy) is a senior wealth advisor and branch manager at Assante Capital Management Ltd.

Canada Mortgage and Housing Corp. (CMHC), that provides insurance for high ratio mortgages, announced in early June that it will ban the use of borrowed funds for a down payment, require a higher credit score (at least 680 instead of 600) from borrowers and try to ensure that homeowners have enough income to pay their mortgages and other debts by lowering gross debt service ratio and total debt service ratio levels.

This toughening of rules by CMHC would make it harder for riskier borrowers to get mortgage insurance and would reduce demand from these types of borrowers and keep real estate prices in check during uncertain economic times.

The new rules took effect on July 1, 2020, and by making it impossible for borrowers who are less likely to make their payments to qualify for CMHC coverage, could reduce demand for homes at a time when real estate sales have dropped due to the recession caused by the COVID-19 pandemic.

According to CMHC's latest quarterly results, nearly 20% of its insured mortgage holders would not have met at least one of its new criteria. These changes are most likely to affect first-time home buyers.

According to CMHC chief executive, Evan Siddal, in a statement accompanying the new rules:

> COVID-19 has exposed long-standing vulnerabilities in our financial markets, and we must act now to protect the economic futures of Canadians. These actions will protect home buyers, reduce government and taxpayer risk and support the stability of housing markets while curtailing excessive demand and unsustainable house price growth.

CMHC has forecast that home prices could drop as much as 18% over the next 12 months.

The stricter requirements apply only to CMHC insurance, which is required for home buyers with a down payment of less than 20%. Borrowers can still get insurance from private insurance companies such as Genworth MI Canada Inc. and Canada Guaranty Mortgage Insurance Co. However, it usually costs more than CMHC coverage. It is not clear at this point whether those private insurers would be adopting CMHC's new criteria.

For new home buyers, it is important to monitor and know their credit scores. Your credit score can range between 300 to 850 and is determined by an algorithm that uses information from your credit report. Paying your bills on time and how much credit card debt you carry can affect your credit score. Lenders use your credit score to approve you for a loan and to decide what interest rate to charge you and how much credit to extend to you which determines your credit limit.

Equifax and TransUnion are two agencies that determine credit scores for Canadians and provide credit reports to lenders. They also offer credit reports, and monitoring for consumers for a price. You can get a free credit score and credit report using websites such as Borrowell (for Equifax) and Credit Karma (for TransUnion).

It is also good to know about gross debt service (GDS) ratio and total debt service (TDS) ratio before you apply for a mortgage.

The GDS and TDS ratios are used by lenders to qualify mortgage applicants and determine if a borrower can manage monthly mortgage or debt payments and repay their loan.

The lender can find out what percentage of your monthly income goes towards paying your housing costs by using the GDS ratio and it can find out what percentage of your income is used to pay debts and other obligations, including rent, credit card bills, child support and car loans.

To qualify for a CMHC mortgage you need a GDS ratio of 35% or less and a TDS ratio of 42% or lower.

To determine your GDS ratio, you can add together your monthly rent/mortgage cost (principal only), the related interest payments, your property taxes and your heating costs and divide by your gross monthly income. For example, if you earn $10,000 in gross monthly income and pay $3,000 per month in rent and $150 per month for heat, then your GDS ratio is $3,150/$10,000 or 35%.

To determine your TDS ratio, you can add together your rent/mortgage principal, related interest, your property taxes, your heat, and other debt obligations and divide the resulting amount by your gross income.

You can also use CMHC's debt service calculator that can be found on CMHC's web site.

Given the new tightened mortgage rules, it is wise to monitor your credit score and to calculate your GDS and TDS ratios before you apply for a mortgage to ensure that you will qualify.

Tina Tehranchian, MA, CFP®, CLU®, CHFC®, MFA-P™ (Philanthropy)is a FP Canada ™ Fellow and a senior wealth advisor and

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