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Should Canadian RESPs and RDSPs Be Exempt From Foreign Trust Reporting?

by Marsha Laine Dungog and Liguo Cooper Xu

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SPECIAL REPORT
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Should Canadian RESPs and RDSPs Be Exempt From Foreign Trust Reporting?

by Marsha Laine Dungog and Liguo Cooper Xu

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In this report, Dungog and Xu recommend that further administrative guidance be issued under section 6048 to clarify that Canadian savings plans and similar arrangements are excluded from annual reporting on forms 3520 and 3520-A.

This report is one in a series of proposals sponsored by the California Lawyers Association Taxation Section and presented to various policymakers and government officials. However, the comments in it reflect the individual views of the authors who prepared them and do not represent the position of the California Lawyers Association.

Although the authors and presenters of this report might have clients affected by the rules applicable to the subject matter of this report and have advised clients on the applicable law, no participant has been specifically engaged by a client to participate on this project.

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I. Executive Summary

The U.S. taxation of contributions, accruals, and distributions from foreign plans that are structured as foreign trusts with U.S. person[1] (USP) owners or beneficiaries remains a controversial area that requires definitive guidance because of the increasing number of USPs residing outside the United States and foreigners relocating to it. The complexity arises in part because many foreign plans do not fit squarely with the types of plans available to U.S. residents in the United States. Until the U.S. tax classification and treatment of foreign plans is addressed by Congress in the code or by Treasury through regulations, the annual U.S. tax reporting of USPs outside the United States and foreign persons who are tax residents in the United States regarding their interests in some foreign plans remains fraught with proverbial "traps for the unwary."

Many foreign plans that are foreign trusts would generally fall within the guidelines of section 6048, which would require USP owners and beneficiaries of those foreign plans to file the Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," and Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner." Without specific guidance from federal tax authorities on many foreign plans, tax

[1] In this report we limit the definition of U.S. person to a U.S. citizen or U.S. lawful permanent resident (a green card holder) as defined in section 7701(a).

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practitioners have defaulted to reporting foreign plans owned by USPs (either directly or beneficially) as foreign trusts subject to requirements for reporting U.S. foreign trusts and subject to the Foreign Account Tax Compliance Act (FATCA) and foreign bank account reporting (FBAR) requirements.

But not all foreign plans that are foreign trusts are subject to reporting requirements under section 6048 itself. For example, some foreign plans that constitute section 402(b) nonqualified deferred compensation trusts are exempted from section 6048 reporting requirements under section 6048(a)(3)(B) as nonqualified foreign trusts under a plan that provides for pensions, profit sharing, stock bonus, sickness, accident, unemployment welfare, and similar benefits.

Treasury should review whether section 6048 applies to the Canadian Registered Educational Savings Plan (RESP) and Canadian Registered Disability Savings Plan (RDSP). The IRS has precedent for exempting other Canadian plans from this requirement, specifically regarding USP owners and beneficiaries of a Canadian Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF). Thus, USP owners and beneficiaries of Canadian RESPs and RDSPs should have no affirmative obligation to file form 3520 or 3520-A because these plans also arguably fall within the exemptions to section 6048(3)(B)(ii) as plans that provide for unemployment welfare and similar benefits.

Moreover, there are sound administrative reasons for exempting RESPs and RDSPs from foreign trust reporting. At the risk of stating the obvious, requiring all foreign trusts to file information reporting returns simply because they are a foreign trust with a USP owner or USP beneficiary not only increases the complexity of U.S. tax return administration and compliance but also unduly strains IRS resources while arguably generating little revenue from such foreign trust filings.[2]

For example, on May 21, 2018, the IRS Large Business and International Division launched six campaigns that included a campaign to improve Form 3520/Form 3520-A compliance, which includes various approaches to noncompliance through examinations and penalties assessed by the IRS Campus when the forms are received late or incomplete. This campaign is only one of 40 active campaigns launched by the IRS since January 31, 2017, to make the best use of IRS knowledge and resources by focusing on compliance issues that have high risk of noncompliance among taxpayers.

The Form 3520/3520-A campaign was intended to improve the taxpayer's and practitioner's knowledge of a U.S. person's requirement to report ownership of and transactions with foreign trusts as well as decrease the percentage of late filed and incomplete forms 3520/3520-A and, as a corollary, increase the number of properly filed forms 3520 or 3520-A. The IRS scope for implementing the campaign includes IRS outreach and education, the issuance of soft letters, the conduct of examinations, and issuance of Campus Penalty Assessments.

USPs who are resident in Canada and have filed forms 3520 or 3520-A to report their respective RESPs and RDSPs as substitute filings in lieu of foreign trustee filings have already received letters from the IRS under the Form 3520/3520-A campaign initiative. We question the effectiveness of those assessments, given that RESPs and RDSPs are low-balance depositary accounts that would be an unlikely offshore vehicle for U.S. tax avoidance by USPs resident in Canada. Further, these accounts have already been specifically excluded from the definition of a financial account and therefore are not treated as U.S. reportable accounts for FATCA reporting requirements for Canadian financial institutions.[3]

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[2]The goal of the campaigns is to make the greatest use of the IRS's limited resources by focusing on high-risk tax issues. For the Form 3520/3520-A campaign, the scope of IRS approaches included IRS outreach and education, the issuance of soft letters, the conduct of examinations, and issuance of campus penalty assessments.

[3]*See* Annex II, Non-Reporting Canadian Financial Institution and Products, Section IV (F) and (G) of "The Agreement Between the Government of the United States of America and the Government of Canada to Improve International Tax Compliance Through Enhanced Exchange of Information Under the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital" (June 27, 2014).

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II. Cross-Border Treatment

A. U.S. Foreign Trust Reporting

In general, section 6048(a) provides that a USP grantor, transferor, or executor must provide a written notice of a "reportable event" with the IRS on or before the 90th day after occurrence of the event, or a later date as the secretary may prescribe.[4] A reportable event means (1) the creation of a foreign trust by the USP *inter vivos*; (2) the transfer of money or property to a foreign trust by a USP (either directly or indirectly); and (3) the death of a USP citizen or resident if the trust was a foreign grantor trust or any portion of the trust is included in the decedent's gross estate.[5] However, not required to be reported under section 6048 are transfers of property to a trust within the context of a sale for fair market value[6] or as contributions made to a nonqualified deferred compensation under a plan that provides for pensions, profit sharing, stock bonus, sickness, accident, unemployment welfare, and similar benefits (as in section 402(b), 404(a)(4), or 404A), or a charitable trust under section 501(c)(3).[7]

U.S. tax law does not provide any definitive guidance on whether RESPs and RDSPs that have a USP grantor, transferor, or beneficiary would constitute foreign trusts exempt from the foreign trust reporting requirements under sections 6048. As the statutory "responsible party" for such filings, USP owners, beneficiaries, and executors of RESPs and RDSPs are subject to the same requirements or risk incurring civil penalties directly. This reporting requirement persists despite previous requests made by various interest groups in Canada to the U.S. Treasury Department to seek relief from this reporting requirement for RESPs and RDSPs.[8]

Failure to file the report under section 6048 would trigger the imposition of penalties under section 6677. The statute of limitations for assessment of penalties under section 6677(a) and (b) only ends three years after a complete and accurate Form 3520/3520-A is filed. The penalties are severe if Form 3520 is not filed on or before the due date (including extensions) of the USP's income tax return, or the Form 3520-A is not filed on or before the 15th day of the third month after the end of the trust year (including extensions), or if the applicable form does not include all the information required or includes incorrect information.[9] Failure to file Form 3520 may subject a USP transferor to a penalty of 35 percent of the amount transferred, and for reports filed after December 31, 2009, there is a minimum penalty of USD $10,000, not to exceed the gross reportable amount.

B. Canadian Treatment of RESPs

Before 1998, RESPs were mere product offerings between private sector providers and client subscribers. However, in 1998, the Canadian Parliament enacted the Canada Education Savings Act (CESA), which introduced CES grants to give incentives to deposit-taking financial institutions to enter the RESP market, so that lower-income families already saving for a child's education could do so using an RESP as a savings vehicle.[10] In 2004 the Canadian federal budget announced the creation of the Canada Learning Bond (CLB) and the ACESG to start education savings for post-secondary education for low-income families.[11] In 2017 RESP assets reached C$55.9 billion, compared with C$23.4 billion in 2007. However, of these amounts, only C$4.67 billion constituted personal contributions from families. The remaining assets were federal and provincial educational savings incentives and accumulated earnings.[12]

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[4] *See also* Notice 97-34, 1997-2 C.B. 422.

[5] Section 6048(a)(3)(A).

[6] Section 6048(a)(3)(B)(i).

[7] Section 6048(a)(3)(B)(ii).

[8] *See* CPA Canada letter (Feb. 25, 2016); American Institute of CPAs letter (Mar. 4, 2016); and American Chamber of Commerce in Canada letter (Mar. 4, 2016).

[9] The initial and continuation penalties range as follows: (1) for filings due before January 1, 2010: from 35 percent of the gross reportable amount (for Form 3520) or 5 percent of the gross reportable amount (for Form 3520-A); and (2) for filings due after December 31, 2009: the greater of $10,000 or 35 percent of the gross reportable amount (Form 3520, Parts I and III); or the greater of $10,000 or 5 percent of the gross reportable amount (Form 3520, Part II and Form 3520A).

[10] *See* Jennifer Robson, "Enhancing Access to the Canada Learning Bond," discussion paper prepared for Canada Education Savings Program, Employment and Social Development Canada (Dec. 2, 2016) (Final Report).

[11] *Id*. at 12.

[12] Canada Educational Savings Program, 2017 Statistical Review.

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The Canadian tax rules offer other tax-deferred or even tax-free treatment for savings vehicles created under CESA. Confusion arises because these savings vehicles are not entitled to the same treatment for U.S. tax purposes when a USP grantor, transferor, or beneficiary is involved.

1. Canadian RESP is structured as a domestic trust.

An RESP is a contract between an individual (the subscriber) and a person or organization (the promoter) to provide funds for post-secondary education financial assistance to another individual, usually the child or grandchild of the subscriber, who must be a resident of Canada. Under the contract, the subscriber agrees to make lifetime contributions of up to C$50,000 for each designated beneficiary, and the promoter agrees to pay educational assistance payments (EAP) to the beneficiaries. A subscriber may relocate to the United States and continue making contributions to the RESP as long as the beneficiary is resident in Canada.

The Canadian federal and provincial governments also contribute to the funding of an RESP. Government funds are, however, limited to a maximum lifetime amount of C$7,500. If the RESP is revoked by the subscriber, or the beneficiary fails to enroll in a post-secondary educational institution, a portion of the RESP that is allocable to government contributions reverts to the Canadian government, while earnings on subscriber contributions are distributed back to the subscriber and taxed accordingly.

While there are some tax practitioners who assert that an RESP does not constitute a domestic trust in Canada, we respectfully disagree. First, what constitutes a trust in Canada does not control its U.S. tax classification. Rather, as the saying goes, "the proof is in the pudding." The RESP must undergo the gamut of U.S. tax classification rules to ascertain its U.S. tax treatment. Second, the RESP is treated as a trust for Canadian tax purposes, although it may not be treated that way in other contexts (such as bankruptcy). A perfunctory review of the process for obtaining RESP status confirms that an RESP can be nothing less than a trust for Canadian tax purposes.

First, the promoter must obtain approval from the Registered Plan Directorate to offer to the public an Educational Savings Plan (ESP). To be approved, the promoter must submit a written specimen plan, which is comprised of many documents, including a declaration of trust, a contract document or agreement that sets out the terms and conditions of the ESP, a prospectus (if applicable), and a trust agreement between the promoter and the trustee.[13]

Second, to obtain RESP status, the ESP must be accepted for registration by the Minister of National Revenue for purposes of the Income Tax Act (Canada).[14] The promoter applies for the registration of the ESP at the request of the subscriber. When approval is obtained, the promoter manages and invests the contributions into the RESP from the subscriber, the Canadian government (under the Canadian Educational Savings Grant (CESG) and CLB), Canadian provincial grants and accumulated investment earnings (collectively, the RESP property). The RESP property is held by a trust company that is licensed in Canada to hold it.

Those formalities for establishing an RESP under Canadian domestic laws show that an RESP must be structured as a trust to receive contributions from the subscriber and federal and provincial governments to fund post-secondary education for the RESP beneficiary. The fact that it may not be respected as a trust in substance in other contexts (such as bankruptcy[15]) does not undermine its treatment as a domestic trust for tax purposes.

2. Tax treatment of Canadian RESP as a trust.

RESPs are taxed under their own provision under the Income Tax Act. Specifically, taxation of RESPs is codified as section 146.1 of Division G,

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[13] *See* IC93-3R2, "Registered Education Savings Plans," at para. 65 (2016).

[14] See section 146.1(2) of the act. To be approved, the ESP must comply with the following conditions under section 146.1(2) of the act: (1) the plan must provide that the property of any trust governed by the plan (after payment of the trustee and administration charges) is irrevocably held by a corporation licensed or authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as a trustee; (2) it must hold the property for purposes of the trust as defined in section 146.1 (for the payment of EAP, the payment to a trust in factor of designated educational institutions in Canada; or the payment to a trust that irrevocably holds property under an RESP); (3) the promoter and all trusts governed by the plan are resident in Canada.

[15] *See* notes to section 146.1(5) of the act citing *MacKinnon*, 2007 SKQB 39, *Payne* (2001), 29 CBR (4th) 153 (Alta QB); *cf. Vienneau*, 2007 NBQB 332.

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"Deferred and Special Income Arrangements of Part 1 (Income Tax)" of the Act.

For Canadian tax purposes, RESPs are treated as a special type of trust subject to its own taxing regime and not the tax regime applicable to *inter vivos* and testamentary trusts under Subchapter K, "Trusts and Its Beneficiaries" of the act.[16] Under section 146.1(5) of the act, a trust that is governed by an RESP is not subject to tax on its taxable income for any tax year unless it holds any properties that are not qualified investments[17] for the trust. This trust treatment for tax purposes persists even though an RESP does not appear to be consistently treated as a trust for bankruptcy law purposes.[18] An RESP is also not subject to deemed disposition rules when an individual emigrates Canada,[19] nor is it subject to disclosure to foreign tax authorities by the Canada Revenue Agency.

Moreover, the subscriber is not subject to tax on RESP income after 1971. Contributions made to the RESP by an individual are not tax deductible.[20] Earnings grow tax-deferred within the RESP up to a maximum of 35 years. Withdrawals from the RESP are permitted to fund beneficiary expenses for post-secondary education. The beneficiary is not taxed on withdrawals of original subscriber contributions, but is taxed on withdrawals representing RESP earnings and government grants,[21] which are reported to the beneficiary student on Form T4A, "Statement of Pension, Annuity and Other Income." Payments made to a nonresident beneficiary would also be subject to withholding taxes on those amounts,[22] subject to rates established under the applicable tax treaty.

If, however, the beneficiary reaches age 21 and has not pursued secondary education, under some conditions the investment earnings may be paid to the subscriber as accumulated income payments that would be subject to Canadian tax.[23] Thus, the subscriber must include in his income this amount, which is taxed at an additional 20 percent.[24] However, in some cases this tax can be reduced by rolling over up to C$50,000 into an RRSP, if contribution room is available, or a spousal RRSP.

Generally, the trustee of an RESP files an information return with the Minister, disclosing the RESP.[25] A promoter may also be required to file information returns for RESPs, but thus far no regulations have been issued.[26]

3. U.S. tax treatment of an RESP.

Because the subscriber to an RESP may reclaim contributions made to the RESP under some conditions (by a revocation of the registered status of the ESP by the Minister or failure by the beneficiary to pursue post-secondary education), tax practitioners have been reporting a USP subscriber who transfers monies to an RESP as a U.S. owner of a foreign grantor trust under sections 671 through 679. As a corollary, the USP subscriber must report the RESP annually by filing Form 3520-A and reporting his ownership of the RESP by completing Part II of Form 3520 under section 6048.

In this respect, it would appear that the USP subscriber is taxed twice: First, contributions made and earnings accrued in the RESP are taxable to the USP subscriber for U.S. income tax purposes, and second, distributions made to the beneficiary (regardless of whether that beneficiary is a USP) are taxable to the beneficiary by Canada, even though the same amounts have already been taxed to the USP subscriber by the United States.[27] Because the USP subscriber and beneficiary are not the same individual, there is

[16] *See* section 108(1) of the act defining the term "trust" as excluding an RESP.

[17] See section 146.1(1) of the act, definition of "qualified investments" includes investments for other deferred plans under section 204 of the act and annuities when the trust is the sole beneficiary.

[18] *See supra* note 15.

[19] *See* section 128.10(a) (iii) and notes under the act.

[20] Section 146.1(6) of the act.

[21] EAP payments would include an RESP's accumulated investment earnings, CESG, CLB amounts, and amounts received from a designated provincial program. An EAP does not include a refund of contributions. *See* IC93-3R2, *supra* note 13, at paras. 35, 53.

[22] *See* section 146.1(7) of the act and notes referencing section 212(1)(r).

[23] Section 146.1(7.1) of the act.

[24] *See* IC93-3R2, *supra* note 13, at para. 20.

[25] *See* section 146.1(13.1) of the act.

[26] *See* section 146.1(15) of the act.

[27] On distribution, the USP subscriber is deemed to have made a gift of the RESP to the beneficiary, which would be subject to U.S. gift tax reporting by filing Form 709, regardless of whether the beneficiary is a USP.

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no ability to offset the Canadian taxes due on distributions to the beneficiary with U.S. taxes previously paid by the USP subscriber.

When the subscriber is not a USP but the beneficiary is, the burden of foreign trust reporting falls on the USP beneficiary. Specifically, a USP beneficiary of an RESP would file an annual Form 3520 to report any distributions received. Those distributions would be taxable to the USP beneficiary for both U.S. tax and Canadian tax purposes. However, because the RESP is reported as an ordinary foreign trust and not a foreign grantor trust, the USP beneficiary theoretically could offset U.S. taxes on distribution amounts with Canadian taxes already paid on the same. The risk that arises, however, with having a USP beneficiary of a foreign trust is the likelihood of triggering throwback taxes for undistributed earnings within the RESP that were prohibited from being distributed to the USP beneficiary before attaining post-secondary education.

4. Canadian RESPs differ from U.S. qualified tuition plans.

While the U.S. qualified tuition program under section 529 has some similarities to the Canadian RESP, it is not subject to the same limitations. Indeed, the 529 plan amounts can be applied to fund not only post-secondary education but also primary and secondary education.[28] More importantly, USP contributors and beneficiaries to a 529 plan are not subject to the same onerous reporting and taxation of contributions, earnings, and distributions from a 529 plan, as explained below.

First, after-tax contributions to a 529 plan are not capped. There is no specific amount of contribution limit because the code directs it only to exceed the amount necessary to provide for the beneficiary's qualified education expenses.[29] Because education expenses in the United States are generally higher than in Canada, the contribution limit for a 529 plan is higher than the RESP's limit of C$50,000. Second, earnings accrued in a 529 plan are not taxable to either the contributor or the beneficiary of the plan if the distributions do not exceed the qualified higher education expenses.[30]

Third, contributions made by a USP to a 529 plan are already treated as a completed gift[31] to the designated beneficiary for U.S. gift tax purposes, even though the contributor may still exercise control over the 529 account. This means that if the contribution exceeds the annual gift tax exclusion of USD $15,000 (the amount for 2019 and subject to inflation adjustment for future years), the contributor can elect to spread it ratably over the five-year period for gift tax reporting purposes. This mechanism allows a USP to avoid potential U.S. gift taxes on a contribution made to a 529 plan that exceed USD $15,000 in 2019 (for example, a total contribution of USD $75,000 made in 2019 can be reported as a series of annual gifts of USD $15,000 from 2019 through 2024). Thus, because a 529 plan contribution is treated as a completed gift in the year made, any financial interest or control retained by the contributor to a 529 plan is not includable in the contributor's estate for U.S. estate tax purposes.[32]

It would therefore appear that a USP who contributes to a 529 plan would not be subject to current U.S. taxes on income and earnings accruing on the account, while the same income and earnings accruing to an RESP account in Canada would be taxable to that same USP and subject to foreign trust reporting requirements for U.S. tax purposes. This raises the question whether a USP should be subject to such disparate treatment by the code, given that USP contributions are intended to provide educational funding for designated beneficiaries (who often would be the USP holder's children or family).

Canadian tax laws do not exempt 529 plans from Canadian income taxes. Therefore, if the USP contributor to a 529 plan is a Canadian resident, the 529 plan is potentially considered a deemed resident trust for Canadian tax purposes or as offshore investment fund property, and subject to higher Canadian trust tax rates and stricter information reporting requirements.

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[28] Section 529(c)(7).

[29] *See* section 529(c)(1).

[30] *Id.*

[31] Section 529(c)(2).

[32] Section 529(c)(4).

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Further, income designated for qualified education expenses under the 529 plan is subject to Canadian income taxation.

C. Canadian Treatment of RDSPs

1. Canadian RDSPs are tax-deferred in Canada.

An RDSP, defined under section 146.4 of the Income Tax Act, is intended to help parents and others save for the long-term financial security of a person who is eligible for the disability tax credit (DTC). An RDSP is a contract between an individual (the holder) and a participating financial institution (the issuer) under which the holder names one beneficiary with a disability and agrees to make contributions, and the issuer agrees to pay disability assistance payments to the beneficiary. In practice, the main features of the RDSP can be summarized as follows:

- Parents or guardians are usually holders and disabled children are usually beneficiaries. If the beneficiary has reached the age of majority and is contractually competent to enter a plan, the beneficiary can open an RDSP for himself.
- The beneficiary may be eligible for the DTC only if a medical practitioner certifies on Form T2201, "Disability Tax Credit Certificate," that the individual has a severe and prolonged impairment in physical or mental functions. This form must also be approved by the CRA, and the person must be deemed to be eligible for the DTC.
- Issuers are usually participating financial institutions that offer RDSPs.
- The contribution is after-tax money. The lifetime limit of contributions per beneficiary is only an accumulation of C$200,000, and it can be made in installments, or once in any year until the end of the year in which the beneficiary turns age 59. The Canadian federal government may provide Canada Disability Savings Grants up to a maximum of C$70,000, and some provincial governments may provide similar incentive subsidies.
- The earnings accrued in the RDSP account are tax-deferred until the distribution is made to the beneficiary.
- The disability assistance payment (DAP) is taxed in the beneficiary's hands but excluding the holder contributions. In other words, only the government grants and the accumulated income are taxable.

Because of the holder's power of control over the RDSP account, tax practitioners have reported the USP holder's interest in an RDSP as a foreign grantor trust under section 671 through 679 and subject to the annual Form 3520/3520-A disclosure requirements under section 6048.

Like the RESP, an RDSP with a USP holder or USP beneficiary is prone to double taxation on the earnings accrued on those amounts. Specifically, a USP holder who reports the RDSP as a foreign grantor trust for U.S. tax purposes would include the RDSP earnings accrued as part of his taxable income for U.S. tax purposes, and report distributions from the RDSP to a beneficiary (USP or otherwise) as a gift subject to U.S. gift taxes and reporting of the same by filing Form 709.

Meanwhile, the beneficiary of an RDSP distribution would be taxed by the Canadian government on DAP amounts received (which are comprised of government grants and accumulated income but excluding prior holder contributions). If the beneficiary is a USP and the RDSP holder is not a USP, this same amount would be concurrently taxed by the U.S. government and subject to foreign trust reporting. The U.S. taxes would be triggered because the RDSP would be reportable by the USP beneficiary as distributions received from either a foreign grantor trust subject to reporting that interest under Part II of Form 3520 and Form 3520-A, or an ordinary foreign trust subject to Form 3520 reporting.

Also, while there is a potential foreign tax credit offset available to the USP beneficiary, the issue that arises is that Canadian tax amounts would reflect taxes on both government grants and earnings on contributions, while U.S. tax amounts should be limited only to earnings on contributions (and not Canadian government grants). Moreover, a USP beneficiary would be unable to claim foreign tax credits for U.S. taxes previously paid by the USP holder on after-tax contributions and earnings that were reported as income from a foreign grantor trust.

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2. Canadian RDSPs differ from U.S. qualified ABLE plans.

While the RDSP has similarities with the U.S. qualified Achieving a Better Life Experience (ABLE) program specified under section 529A, there are significant differences that support exemption of an RDSP interest from foreign trust reporting by a USP holder or USP beneficiary.

First, the annual contribution to the ABLE program is limited to the annual gift exclusion amount of USD $15,000 (the amount for 2019 and subject to inflation adjustment for future years).[33] For an employee beneficiary's own contribution, there is additional contribution room equal to the lesser of his or her compensation income and the poverty line amount, if specific conditions are met. Thus, the total potential contribution limit could be more than the lifetime limit of C$200,000 for RDSP.

Second, ABLE distribution amounts taxable to the beneficiary do not include amounts used for the qualified disability expenses that are broadly defined under section 529A(f)(5).[34] These expenses include education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses approved by the Secretary under regulations and that are consistent with the purposes of section 529A(f)(5). That is in stark contrast to RDSP amounts, which are all taxable to the plan's beneficiary.

Lastly, ABLE contributions are treated as complete gifts to the beneficiary even though the contributor may still have control of the ABLE account.[35] Therefore, a USP who contributes to an ABLE account would not be taxed on income and earnings accrued thereon, while the same income and earnings accruing to an RDSP account in Canada would be currently taxable to a USP holder and subject to foreign trust reporting requirements for U.S. tax purposes. This raises the question whether the code should subject a USP to such disparate treatment, even if the USP contributions are allocated to provide disability support to the designated beneficiaries (who often would be the USP children).

There is no exemption provided for a section 529A plan for Canadian tax purposes. Therefore, if the contributor to a section 529A plan is a Canadian resident, the plan is potentially considered a deemed resident trust for Canadian tax purposes or as offshore investment fund property subject to Canadian information reporting requirements. Further, income designated for qualified education expenses under section 529A plans is subject to Canadian income taxation.

III. U.S. Classification of RESPs and RDSPs

Various groups have previously sought exemption of RESPs and RDSPs from U.S. information reporting requirements under FATCA.[36] None of these prior submissions have asserted that RESPs and RDSPS would not be treated as foreign trusts under U.S. tax laws. We concur that an RESP and RDSP arrangement would likely constitute a trust because it satisfies the code definition of a trust arrangement (as discussed below). In summary, RESPs and RDSPs are trust arrangements primarily because their purpose is to vest in a third-party financial entity, as trustee, with sole responsibility for protecting and conserving contributions made into the RESP or RDSP to provide funds for an individual's post-secondary education (for the RESP) or supplemental income in the case of a disability (for the RDSP).

It is important to note, however, that the subscriber to an RESP or RDSP is not the only contributor to the trust. Various federal and provincial government monies are also contributed to the RESP and RDSP, so it would be erroneous to treat the entire amount in the RESP and RDSP as solely attributable to the subscriber

[33] Section 529A(b).

[34] Section 529A(c)(1).

[35] Section 529A(c)(2).

[36] *See, e.g.*, RESP Dealers Association of Canada, "Comments on Proposed Rules (REG-1216487-10) on FATCA Information Reporting and Withholding by Foreign Institutions" (July 24, 2012); AICPA letter to Treasury on proposed tax relief for U.S. and Canadian tax savings plans (Mar. 4, 2016); RBC Financial Group letter to Treasury about FATCA provisions in the Hiring Incentives to Restore Employment Act of 2010 (Sept. 3, 2010).

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for purposes of foreign grantor trust reporting. Individual beneficiaries do not participate in the management of contributions made to an RESP or RDSP.

A. Section 7701(a)(30)(E) and (31)(B)

In 1996 Congress enacted section 7701(a)(30)(E) and (31)(B) to create a "strong statutory bias in favor of foreignness"[37] regarding the nationality of a trust. Under those provisions, both conditions are satisfied if (1) a court or courts within the U.S. are able to exercise primary supervision over administration of the trust (the court test); and (2) two or more U.S. persons have the authority to control all substantial decisions of the trust (the control test).

A trust satisfies the court test if "a court within the United States is able to exercise primary supervision over the administration of the trust."[38] This includes federal, state, or local courts physically located within a state of the United States or the District of Columbia, and excludes courts located in U.S. territories and possessions and courts in foreign countries.[39] The term "primary supervision" means that the U.S. court must "have the authority to determine substantially all issues regarding the administration of the entire trust, and the ability to issue orders or judgments related to such administration."[40] These include duties imposed by the terms of the trust instrument and applicable law, such as maintaining books and records, filing trust tax returns, managing and investing assets, defending the trust from creditor lawsuits, and determining the amount and timing of the distributions.[41] Application of the foregoing considerations to the RESP and RDSP would cause both Canadian registered plans to fail the court test.

A trust satisfies the control test if "one or more United States persons have the authority to control all the substantial decisions of the trust."[42] Treasury regulations define the term "substantial decision" as any decision permitted or required under the trust instrument that is not a "ministerial decision."[43] Examples of ministerial decisions include decisions related to trust bookkeeping, the collection of rents from trust property, and the execution of investment decisions.[44] These examples support the proposition that a decision is substantial for purposes of the control test if it involves an exercise of discretion. The regulations also provide that the power to remove, add, or replace a trustee is a substantial decision, as is the power to appoint a successor trustee subject to specific conditions.[45] Reg. section 301.77017(d)(v), Example 1, provides an example of a trust that fails the control test because it has three fiduciaries, one of whom is a nonresident alien. Because the fiduciaries in the example must make unanimous decisions, the trust will fail the control test because U.S. persons do not have control over all the substantial decisions of the trust.[46] Therefore, even if a trust were created by a USP, all its assets were located in the United States, and all its beneficiaries were USPs, the trust may be a foreign trust as long as a foreign person has control over one substantial type of trust decision.

Applying the control test to the RESPs and RDSPs would lead to the conclusion that both should fail the control test because both are managed and administered by a Canadian corporate trustee, as required under Canadian domestic laws. In this regard, it does not matter that the RESP and RDSP have a USP subscriber or holder who may also have authority to make substantial decisions regarding the investments of the RESP or RDSP. The important factor is the presence of a foreign trustee.

Because both the RESPs and RDSPs would fail the court test and the control test, each of these

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[37] *See* Ellen K. Harrison, Elyse G. Kirschner, and Carolyn McCaffrey, "U.S. Taxation of Foreign Trusts, Trusts With Non-U.S. Grantors and Their Beneficiaries," in *International Trust and Estate Planning 2018*, 4 (ALI San Francisco).

[38] Section 7701(a)(30)(E)(i).

[39] *See* reg. section 301.7701-7(c)(3)(i) and (ii).

[40] *See* reg. section 301.7701-7(c)(3)(iii) and (iv).

[41] *See* reg. section 301.7701-7(c)(3)(v).

[42] *See* section 7701(a)(30)(E)(ii). *See also* LTR 200243031, LTR 200311034. Conversely, if the foreign person has the authority to control any substantial decision of the trust, the trust fails the control test and will be classified as a foreign trust.

[43] *See* reg. section 301.7701-7(d)(1)(ii).

[44] *Id*.

[45] *See* reg. section 301.7701-7(d)(1)(ii)(H) and (I).

[46] *See* reg. section 301.7701-7(d)(v), Example 1.

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types of Canadian registered plans would be classified as a foreign trust for U.S. tax purposes.

B. Reg. Section 1.7701-4

Under reg. section 301.7701-4(a) in an ordinary trust, trustees take title to the trust property with the objective of protecting and conserving it for the benefit of the trust beneficiaries.[47] Specifically, in an ordinary trust the beneficiaries are not associates in a joint enterprise for the conduct of business for profit.[48] Conversely, there are other arrangements known as "trusts," but they are not classified as trusts for the purposes of the code because they are not simply arrangements for the protection or conservation of the property for the beneficiaries.[49] In those circumstances, if the beneficiaries or unitholders of the trust have voluntarily associated for the primary purpose of carrying on business through the trust with the primary objective of earning profits, the trust is likely to be classified as a business trust and treated as a business entity.[50]

Treasury regulations[51] and case law[52] on this issue look to the "associates test" and "business purpose test" to determine whether a foreign trust will be classified as a business entity (that is, as an association taxable as a corporation) rather than an ordinary trust.[53] A foreign trust will be deemed an association only if it has both associates and a business purpose.[54] The presence of associates in the trust structure, combined with proof of a business purpose, is a dispositive factor in determining whether a trust is a business entity rather than an ordinary trust.

The associates test and business purpose test were established in *Morrissey*,[55] *Elm Street*,[56] and *Coleman-Gilbert Associates*.[57] These cases articulated the need to review the trust deed to determine the composition of the trust, along with the nature and scope of the activities authorized by the trust deed. In *Morrissey* and *Coleman-Gilbert Associates*, the Court found that a business purpose existed when the trust instrument granted broad powers for the use of trust property in an active business. In *Elm Street*, the Court determined that the presence or absence of associates will often be determinative for the classification of the trust.

To that end, any beneficiary whose voluntary participation in the trust also involves its active operation will trigger associate status.[58] Further, broadly authorized activities, even when not acted upon, may trigger associate status.[59] From the standpoint of a business purpose, challenges arise when the trust engages too extensively in business activities. As with associates, the courts have determined that a business purpose will be identified within the language of the trust deed.[60] Thus, when a trust deed grants to the trust the authority to conduct business with the trust property, a business purpose will be established.[61]

Under the Treasury regulations and case law, four factors are especially relevant when determining the treatment of a trust as an ordinary trust or a business entity: (1) the reason for creation of the trust; (2) the terms and conditions outlined in the trust deed; (3) the business purpose behind the trust; and (4) the presence of any associates in the trust.

Regarding an RESP, a perfunctory review of the trust arrangement between the promoter, the trustee, and the subscriber should disclose that the sole purpose of the trust is to provide for payment of EAP for the beneficiary's post-secondary education because those conditions are required for approval of the RESP by the minister. Further, the trust terms and conditions should reflect the provisions for the taxation of the RESP under section 146.1 of the ITA, which reflect the

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[47] Reg. section 301.7701-4(a).

[48] *Id.*

[49] Reg. section 301.7701-4(b).

[50] *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

[51] Reg. section 301.7701-2(a)(1), -(4)(a) and (b).

[52] *Morrissey*, 296 U.S. 344; *see also Helvering v. Coleman-Gilbert Associates*, 296 U.S. 369; *see also Elm Street Realty Trust v. Commissioner*, 76 T.C. 803 (1981).

[53] Reg. section 301.7701; *see also Morrissey*, 296 U.S. 344.

[54] Reg. section 301.7701-2(a)(2).

[55] *Id.*

[56] *Elm Street*, 76 T.C. 803.

[57] *Coleman-Gilbert Associates*, 76 F.2d 191.

[58] *Morrissey*, 296 U.S. 344.

[59] *Id. See also Coleman-Gilbert Associates*, 76 F.2d 191.

[60] *Id.*

[61] *Id.*

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tax-favored treatment of the RESP to the extent the trust is managed and invested to primarily fund the beneficiary's post-secondary education with subscriber contribution monies as well as CESG and CLB grants. Because the RESP is meant to provide for post-secondary education, it appears that there would be no further business purpose for the trust except to generate interest and income on the contributions made by the subscriber as well as federal and provincial grants made to grow principal sufficient to fund future disbursements. Most importantly, the beneficiaries of an RESP do not voluntarily participate in the business activities of the RESP and would therefore not be classified as associates to the trust.

We would extend the same analysis to an RDSP.

C. Foreign Grantor Trust Treatment

Section III of Notice 9734, 1997-2 C.B. 422, states that one purpose of the section 6048(a) reporting requirements is to ensure that U.S. transferors comply with section 679. This provision generally treats a U.S. person as the owner of a foreign trust if the U.S. person transfers property to the foreign trust and the trust could benefit a U.S. person. However, a U.S. person will not be treated as the owner of the trust under section 679 if, in exchange for the property transferred to the trust, the U.S. person receives property whose value is at least equal to the FMV of the property transferred.[62]

1. Definition of grantor.

Under section 679, a USP is treated as the owner of a foreign trust's income, gain, and loss when she is the grantor of a foreign trust, even if the trust would not otherwise be a grantor trust under the grantor trust rules. A grantor is a person (individual or entity) who either creates a trust directly, or indirectly makes a "gratuitous transfer" of property to a trust.[63] In this regard, a person who creates or funds a trust on behalf of another person (an accommodation grantor) will be treated as a grantor, but only a person who makes gratuitous transfers will be treated as the owner of the trust.[64] A gratuitous transfer means a transfer other than a transfer made for FMV.[65]

Applying the definition of grantor to the structure of an RESP and RDSP results in more than one grantor who would be treated as the owner of the RESP or RDSP for U.S. tax purposes. These grantors include the USP subscriber or holder who contributes after-tax monies to the RESP or RDSP, as well as the Canadian federal and provincial governments that contribute educational and disability assistance program grants to the RESP or RDSP. The implication of this is clear: When a USP subscriber or holder is treated as the owner of the RESP or RDSP under the foreign grantor trust rules, not all the income and earnings accrued under the RESP or RDSP are reportable by the USP for purposes of Form 3520A and Form 3520. Rather, only the portion of the RESP or RDSP that represents the USP subscriber or holder's share of income and earnings accrued in the RESP or RDSP, and subsequent distributions made to the USP beneficiary, would present computational challenges[66] that would be prone to mistakes and errors reflected on the Form 3520A/3520 itself.

2. Who is not a grantor.

Reg. section 1.671-2(e)(6), Example 4, illustrates that a person who has the right to withdraw assets from the trust is not a "grantor," although that person would be treated as an owner of the trust under section 678 if she were a USP. This brings us to the issue of whether a USP subscriber to an RESP or RDSP does possess this power under Canadian domestic laws.

IV. Inadvertent Section 6048 Reporting Errors

Application of foreign trust reporting requirements to the Canadian registered plans presents complicated and unduly burdensome

[62] Section 679(a)(2)(B).

[63] Reg. section 1.671-2(e).

[64] Reg. sections 1.671-2(e)(1) and 1.679-3(c); Example 3 of reg. section 1.671-2(e)(6).

[65] A transfer for FMV means a transfer in consideration for and equal to the value of (i) property received from the trust (other than an interest in the trust); (ii) services rendered by the trust; or (iii) the right to use property owned by the trust. A transfer may be gratuitous without regard to whether it is a gift for gift tax purposes and without regard to whether gain is recognized on the transfer. *See* Harrison, Kirschner, and McCaffrey, *supra* note 37, at 137.

[66] Reg. section 1.671-3(a)(2).

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reporting obligations on a USP subscriber, holder, or beneficiary given the relatively small amounts of monies allowed in these foreign accounts.

A. USP Beneficiary of Foreign Trusts

Generally, a U.S. citizen or resident beneficiary must report his interest in a foreign trust to the IRS on Form 3520 under section 6048. Form 3520 must be filed with the IRS Service Center in Ogden, Utah, separately from the USP beneficiary's individual income tax return regarding distributions. This reporting requirement applies regardless of whether the distribution is from a foreign grantor or nongrantor trust.

Regarding a distribution from a foreign nongrantor trust, the USP beneficiary must receive a "Foreign Nongrantor Trust Beneficiary Statement" that indicates the exact composition of the distribution to treat it as a gift for U.S. tax purposes not subject to income tax. Otherwise, the IRS would presume that the distribution is an accumulation distribution and therefore subject to throwback taxes. In the absence of this statement and sufficient information from the trustee of the foreign trust to make accumulation distribution computations under the rules, the USP beneficiary must compute throwback tax using the IRS default method.[67] Needless to say, this undertaking is prone to errors and mistakes and would likely trigger inaccuracies reported on the Form 3520 filed by the USP beneficiary. Those errors and mistakes would be attributable to the fact that RESP or RDSP distribution amounts are comprised of after-tax contributions from a subscriber or holder, Canadian government grants, and earnings accrued on those amounts. A USP beneficiary must be able to allocate the contributions to each source and trace earnings attributable thereto to arrive at the correct amount of U.S. taxes payable only on the subscriber contributions and earnings.

Foreign trust reporting for a USP beneficiary of a foreign grantor trust (with a USP subscriber or holder), however, would not be plagued with the same complexities. In the case of a distribution from a foreign grantor trust, the USP beneficiary would be deemed to have received a gift for U.S. income tax purposes and would not implicate any distributed net income or undistributed net income from the foreign trust to the USP beneficiary.[68] Further, the deemed gift would not be subject to any federal income taxes to the USP beneficiary under section 102.

B. USP Grantor of Foreign Trusts

A foreign trust that is treated as a grantor trust for a USP must file an annual report of the trust's activities and operations for a calendar year with the IRS.[69] The trust must file Form 3520-A each calendar year and attach a "Foreign Grantor Trust Statement." The trustee must send a copy of the statement to the USP subscriber or holder of the RESP or RDSP and each beneficiary who received a trust distribution in the applicable year. The USP subscriber or holder is responsible for ensuring that the RESP or RDSP files a Form 3520-A,[70] which must be filed on March 15 of each year. The IRS can impose a penalty of failing to file Form 3520-A of 5 percent of the gross value of the trust assets.[71]

The instructions to Form 3520 also direct the USP subscriber or holder who is treated as the owner of the income, gain, and loss of an RESP or RDSP that is treated as a foreign grantor trust to file an IRS Form 3520 for each year in which the trust is a grantor trust. That is in addition to the Form 3520-A requirement. However, unlike the Form 3520A, the Form 3520 is filed independently and separate from the USP subscriber or holder's individual Form 1040 with the service center in Ogden.

In addition to the filing date variances between forms 3520 and 3520-A, a USP subscriber or holder who is treated as the owner of an RESP or RDSP that is a foreign grantor trust must keep track of the sources of contributions to the trust and trace earnings accrued on each source. As noted, an RESP and RDSP as a foreign trust generally has more than one grantor; funds contributed to these accounts are comprised of

[67] *See* 2017 Instructions for Form 3520, at 9.

[68] *See* Notice 97-34, Section VI(A).

[69] Section 6048(b)(1)(A).

[70] Notice 97-34, Section IV(A).

[71] Section 6677(a).

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contributions from a USP subscriber, the federal government of Canada, and provincial governments. Accurate foreign trust reporting of an RESP or RDSP account by a USP subscriber or holder would require hairsplitting of contributions from each grantor, and earnings and distributions apportionable to each of those contributions to be able to isolate the correct amounts that would be included in the USP subscriber or holder's taxable income for U.S. tax purposes. Given the relatively small amounts involved with these accounts, the risk of inaccurate reporting on the forms 3520 and 3520-A is high. Many well-intentioned taxpayers would get caught and penalized at such high costs.

1. Section 1471 and reg. section 1.1471-1 et seq.

RESPs and RDSPs are specifically excluded from the definition of a financial account and therefore not treated as a U.S. reportable account for purposes of the FATCA reporting requirements for Canadian financial institutions.[72] While we cannot definitively state the reason for excluding these foreign plans from FATCA reporting, we do note that Canadian institutions wrote letters to Treasury and filed comments with the IRS requesting such an exemption on the grounds that RESPs and RDSPs were often low-balance accounts, and therefore presented a low-risk vehicle for tax evasion by U.S. taxpayers outside the United States who held interests in such accounts.

V. No Relief Under Tax Treaty

Article XVIII of the U.S.-Canada Income Tax Convention (Tax Treaty)[73] has been amended time and again to provide reduced rates of withholding and exemptions from taxation by one country of some retirement, pension, and savings accounts established by a resident of the other country. Indeed, Article XVIII has provided bilateral tax deferral of some qualified or registered pension or retirement plans as well as government assistance payments such as social security, privately funded alimony, and child support payments.

However, this provision does not go far enough to provide any relief from double taxation or current income inclusion of contributions, earnings, and income accrued to RESPs and RDSPs, which serve similar purposes as the section 529 and ABLE Plans in the United States. The result is that a U.S. taxpayer who contributes to a section 529 plan in the United States and an RESP in Canada is taxed by the United States on after-tax contributions and earnings accrued to the Canadian RESP while being altogether exempted from taxes on contributions, earnings, and distributions made from a section 529 plan.

Further, the same U.S. taxpayer risks substantial foreign trust reporting penalties on late-filed, inaccurate, or erroneous Form 3520/3520-A filings made to report her interests in the Canadian RESP. This disparate tax treatment is a burden that only applies to a U.S. taxpayer with a cross-border lifestyle. The number of U.S. taxpayers with cross-border activities and interests is increasing, and so there is a pressing need to address the issues of RESP and RDSP reporting and taxation. The American Chamber of Commerce in Canada has previously requested that Treasury provide tax relief for millions of U.S. taxpayers who reside abroad and are subject to double taxation or current income inclusion for contributions and earnings in Canadian RESPs and RDSPs, noting that the adverse tax consequences apply to[74]:

- Americans living in Canada;
- Canadians living in the United States;
- Americans living in the United States who contributed to one of the Canadian plans while living in Canada; and
- Canadians living in Canada who contributed to one of the United States plans while living in the United States.

[72] *See* Annex II, "Non-Reporting Canadian Financial Institution and Products, Section IV (F) and (G) of the Agreement Between the Government of the United States of America and the Government of Canada to Improve International Tax Compliance Through Enhanced Exchange of Information Under the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital" (June 27, 2014).

[73] "Convention Between the United States of America and Canada With Respect to Taxes on Income and Capital" (Sept. 26, 1980), as amended by protocols on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997, and September 21, 2007.

[74] *See* letter to Treasury Secretary Mark Mazur et al. from Jim Yager, American Chamber of Commerce Canada (Mar. 4, 2016).

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Canadians with RESPs and RDSPs looking to relocate to the United States often opt to liquidate these accounts rather than face the unfavorable tax treatment of those accounts in the United States. In the same vein, U.S. persons resident in Canada who are deemed to own RESPs or RDSPs for foreign trust reporting purposes have considerable hurdles to overcome to accurately and timely report their respective interests in RESPs or RDSPs or risk incurring substantial penalties. The adverse impact of these actions on cross-border trade and mobility cannot be understated.

VI. Conclusion

We note that the U.S. tax treatment and reporting of Canadian tax-deferred plans such as RRSPs provides an example of timely and effective administrative action undertaken by the IRS to clarify and streamline the U.S. taxation and reporting of foreign pensions. Initially, the IRS classified the RRSP as equivalent to a U.S. IRA that did not meet the strict qualifications of section 408(a),[75] so that USP owners and beneficiaries of a Canadian retirement plan were subject to U.S. tax on accrued yet undistributed income in the plan.[76] Thus, USPs with contributions to, distributions from, and ownership of an RRSP for which an election to defer U.S. tax on accrued income under Article XVIII(7) was available, were previously obligated to file Form 3520 and Form 3520-A returns under section 6048.[77]

However, the IRS issued a series of administrative guidance that explicitly exempted USP owners and beneficiaries of Canadian RRSPs and RRIFs from current U.S. tax and foreign employee trust reporting requirements, while USP owners and beneficiaries of other similar Canadian registered plans such as the Canadian RESP and RDSP were not included.

Given that the purpose of foreign trust reporting is to effectively monitor the use of offshore trusts as a vehicle for tax avoidance, we note that RESPs and RDSPs present a low risk of facilitating tax evasion because of their lifetime contribution limitation thresholds and strict regulation by CRA. Therefore, exempting RESPs and RDSPs from annual foreign trust requirements would alleviate administrative burdens and costs to the IRS in administering the foreign trust reporting program.

We recommend that further administrative guidance be issued under section 6048 to clarify that Canadian RESPs, RDSPs, and similar arrangements should be excluded from annual reporting on Form 3520 and Form 3520-A. ■

[75] *See* Rev. Proc. 89-45, 1989-2 C.B. 596, *superseded by* Rev. Proc. 2002-23, 2002-1 C.B. 744. Rev. Proc. 89-45 provided guidance for applying former Article XXIX (5) of the Tax Treaty.

[76] *See* U.S.-Canada Tax Treaty Article XVIII (8). *See also* Rev. Proc. 2014-55, 2014-44 IRB 753, at section 2.01.

[77] *See* Rev. Proc. 2014-55, at section 2.04.

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