BRUNTON'S

U.S. Taxletter

FOR CANADIANS

Covering U.S. Aspects of U.S. Citizens or U.S. Residents with Canadian Income or Assets, and Canadians with U.S. Income or Assets

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LEGISLATIVE/ADMINISTRATIVE/ JUDICIAL UPDATE

Will You Be Permitted to Enter the US After December, 2006?

Of course you will. But there may be new requirements that are not clear as we go to press. A big deadline is technically approaching. Please see the article ***"WILL YOU BE PERMITTED TO ENTER THE US AFTER DECEMBER, 2006?"***

New Jersey Court Issues "Nexus" Bombshell

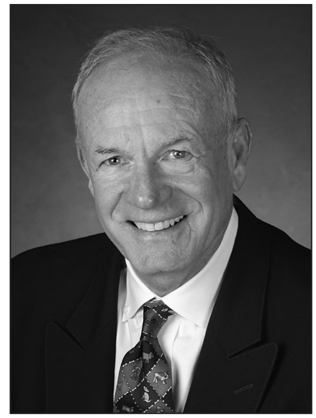
The New Jersey Supreme Court has decided that New Jersey may apply is business tax despite a taxpayer's lack of <u>physical presence</u> in the State. The court stated that the <u>US Supreme Court's</u> decision in Quill Corp v. North Dakota, 504 U.S. 298 (1992) should be limited to matters of sales and use tax. (Lanco, Inc. v. Director of Taxation, New Jersey Supreme Court, A- 89-02, October 12, 2006). Thus, for the moment, <u>physical presence</u> is <u>not</u> required for "nexus" for income tax in New Jersey.

Legislation Introduced to Stop Tax Collection by Private Entities

Proposed legislation (S. 3887) was introduced in the Senate on September 12th to stop the IRS from partially privatizing tax collection. Please see the article ***"WHO'S THAT KNOCKING AT MY DOOR?"***

IRS Backs Off a Little on the "Foreign Housing Exclusion"

As a result of much criticism the IRS has issued a Notice that liberalizes the US income rules for the foreign housing exclusion. Please see the article "***HOUSING EXCLUSION RULES LIBERALIZED***".



RICHARD BRUNTON HOLDS A MASTERS DEGREE IN TAXATION/ACCOUNTING, IN WHICH HIS PRIMARY INTEREST HAS BEEN INTERNATIONAL TAXATION. HE HAS BEEN A RESIDENT OF FLORIDA FOR THE PAST 35 YEARS.

Florida Intangible Tax Repealed

Effective January 1, 2007, the Florida "Intangible Tax" on individuals has been repealed.

2007 Inflation Adjusted Figures Announced

The IRS has announced the following inflation adjusted figures for 2007:

For Expatriation Rules - "Average Annual Net Income Tax" (for five years) - $136,000.

Foreign Earned Income Exclusion - $85,700.

Annual Gift Tax Exclusion - $12,000 ($125,000 for gifts to a non-citizen spouse).

New Information Exchange Agreement

A Tax Information Exchange Agreement between the US and the Isle of Man entered into force on June 26th.

CANADIAN BUSINESSES WITH US CUSTOMERS

Canadian businesses that sell products or services to US customers often service their

*ADDRESSES ONLY U.S. FEDERAL ISSUES -- STATE AND LOCAL ISSUES MAY ALSO APPLY.
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US customers via contact solely from Canada. In these cases: the US customers are never visited by employees or agents; there are no agents in the US; any products sent into the US are sent by common carrier; there is no advertising directed at any US geographical area; and there is no other physical presence in, or connection with, the US. In these circumstances there may be no US federal or State tax requirement for the Canadian business. (But please see "***New Jersey Court Issues "Nexus" Bombshell***", above).

However once any of those facts change a plethora of US federal and/or State obligations may arise, both for the Canadian business and for any Canadian employee that spends time in the United States. Some of these potential issues are:

1) US federal income tax for the business,

2) Registration requirements within States in which the business operates,

3) State income tax, for the business,

4) State franchise tax for the business,

5) State sales tax for the business,

6) US federal income tax wage withholding for a Canadian employee that works in the US, and

7) State income tax wage withholding for a Canadian employee that works in the US.

US Federal Income Tax for the Business

A US income tax filing requirement arises for a Canadian business if it is "engaged in a trade or business" in the US. There is no precise definition of "engaged in a trade or business" in the US. Generally you are engaged in US business if your US activity is "considerable, continuous, and regular".

However, even if you are engaged in US business and must make a tax return filing, readers are aware there will be no actual US federal income tax liability on the business income for the Canadian business if the business does not have a "permanent establishment" ("PE") in the United States. In order to claim the exemption from tax you must file a US income tax return and claim the exemption under Article VII of the tax treaty. For a brief summary of the rules for a PE please see the article "***REVIEW OF THE CONCEPT OF PERMANENT ESTABLISHMENT***".

The (generally) 3-year statue of limitations rule will not commence until you file the income tax return. Thus, failure to make the tax filing and claim the treaty exemption will result in that particular tax year being potentially subject to attack by the IRS at any time in the future.

Of course if your business does have a PE in the US then you may have a US federal income tax liability. In that case you are normally involved with a detailed calculation to allocate and apportion the worldwide expenses of the business between Canadian and US sources. The US has regulations that describe how to make these allocations and apportionments.

If you anticipate a federal tax liability, you may be required to make installment (estimated) tax payments. Please see the article "***US TAX INSTALLMENT PAYMENTS REQUIRED BY CORPORATIONS***" in the Summer, 2005, issue of the Taxletter.

Registration Requirements for States

Most States, even those without a State income tax such as Nevada, require businesses conducting business in the State to register with the State and appoint a "registered agent" within the State. There is usually a penalty for failure to register. In Florida there is a potential penalty of $1,000 per year for failure to register.

Once you have registered there is normally an annual requirement to renew the registration, and usually a penalty for late renewal. Most States will send a renewal Form to the address it has on its records. If this is the address of your registered agent you must ensure the Form is passed along to you. Alternatively you can renew on-line (if you remember to do so).

This registration requirement may be with a different agency within the State Government than the agency that administers the State tax laws. Nonetheless there is an opportunity for one agency to communicate with the other. Thus, for example, if you register but do not file an income tax or sales tax return, you may receive an enquiry from the State asking why you have not filed a tax return. The reverse can also occur if you file a tax return but fail to register.

State Income Tax and Franchise Tax

Income Tax - If you are conducting business and have "nexus" within a State you may be subject to income tax within that State. The State's threshold for determining whether you are conducting business in the

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State is usually very low. A few visits by your sales personnel to a particular State may result in that State considering you to be conducting business there.

Franchise Tax - The US constitution prevents a particular State from levying income tax on an out-of-State business if the business constitutes solely of the solicitation of orders in the State for the sale of tangible personal property in the State, which orders are sent outside the state for approval or rejection.

This exclusion was partly responsible for the States developing the concept referred to as a "franchise tax". The franchise tax is not an income tax. It is a tax based on the right to operate within the State. Generally it is computed on the portion of the capital of your business that is allocated to the State, according to allocation rules promulgated by the State. Fortunately in most cases the franchise tax is small relative to the potential income tax.

As above, a few visits by your sales personnel to a particular State may result in that State considering you to be conducting business and having "nexus" there. Once you have made that "connection" to the State, it may be difficult to "shake". As long as you continue to have customers in that State, the State may continue to consider you to be conducting business there, even if there are no further visits by any of your personnel. Unfortunately each State has a different set of rules, so the analysis of your obligations may have to be done on a State-by-State basis.

State Sales Tax

The potential application of State sales tax can often be the most terrifying because of the very low threshold for its applicability – i.e. for "nexus". If you are not eligible for an exemption under the State rules, a mere one–time visit to the State by an independent sales agent may subject you to sales tax in that State.

A detailed description of "nexus" will be included in the next Taxletter.

US Federal and State Income Tax Withholding on Canadian Employees Working Temporarily in the US.

For a brief summary of the US federal income tax wage withholding rules for a Canadian employer that sends a Canadian employee to work temporarily in the US please see the article "***US WAGE WITHHOLDING IN CROSS BORDER CIRCUMSTANCES".***

POSSIBLE "DEATH BED" US ESTATE TAX PLANNING FOR NONRESIDENT ALIENS

Nonresident aliens with US real estate may not undertake US estate tax planning for one or more of several reasons such as:

1) The US tax exposure is minimal or nonexistent,

2) There is a lack of awareness of the tax,

3) The individual is confident the US property will be sold long before the age is reached that death becomes more likely,

4) The US property is jointly owned and it is (incorrectly) assumed that one-half will be automatically excluded from tax, or

5) The facts are such that no plan is practical.

However, even absent estate tax pre-planning, there may be estate tax actions that can be taken if death suddenly becomes imminent. This may arise, for example, if the individual is unexpectedly diagnosed with a life-terminating illness and a very short life expectancy.

In order to reduce or eliminate the estate tax on the US real estate, the family or others may propose ideas such as:

1) Giving the real estate to the spouse or other family member,

2) Selling the property to the spouse or other family member, or

3) Placing a non-recourse mortgage on the property.

Of course, Canadian income tax issues must be considered before taking any action.

Giving the Property to the Spouse other Family Member

A gift of the US real estate to another party is usually a taxable event in the US. The US gift tax rules apply when a nonresident alien gives US real estate to another person. There is a $12,000 annual exclusion from the taxable amount per donee ($125,000 in 2007 in the case of a nonresident alien donee-spouse, and an unlimited amount in the case of a US citizen donee-spouse). The gift tax rate is the same as the

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estate tax rate but there is no tax treaty benefit for gifts. Thus in many cases there is little or no benefit to making the gift. Exceptions may apply however if:

a) the value of the property is relatively small, or

b) a genuine mortgage can be placed on the property.

The Value is Relatively Small. - In these cases the $125,000 exemption may be a sufficiently high percentage of the value of the property to significantly reduce the estate tax if the gift is made. For example if the property is valued at $300,000, a gift of $125,000 to your spouse may reduce the estate tax by 42,000. The gift may be accomplished by using a "tenants-in-common" deed.

A Mortgage is Placed on the Property. - The US gift tax is based on the value of the property given. Thus, if a property worth $500,000 is subject to a mortgage of $350,000, the "value" of the property given is only $150,000. However in order to defeat any IRS attack it is likely the mortgage would have to be genuine and not a sham. For example if the donee had no means to make the mortgage payments the IRS might argue the mortgage was a sham and attempt to levy gift tax on the entire value of the property.

Where the mortgage is not a sham, a combination of the $125,000 gift to the spouse plus the mortgage could also be considered.

Selling the Property to the Spouse other Family Member

If the US real estate is sold to the spouse or a family member there will be US income tax (capital gains tax) to the extent there is a taxable gain. However this income tax may be less than the potential US estate tax. But if the sale is tantamount to a "sham" the IRS may argue that the transaction was a gift rather than a sale and attempt to levy gift tax.

For example, if the wife purchases the property via funds given to her by her husband immediately before the purchase, the IRS may claim a taxable gift of the US real estate had occurred. Similarly, if the sale from one spouse to the other was financed by the seller-spouse, via a mortgage taken back from the buyer-spouse, the IRS may argue a gift of the real estate occurred if the buyer-spouse had no practical means of covering the carrying charges on the mortgage.

Another Alternative

Another alternative that may be practical in some "death bed" circumstances involves transferring the Canadian property owned by the potential decedent.

Readers are aware the Canada-US tax treaty provides for a "unified tax credit" that can be offset against the US estate tax liability. The amount of this tax credit is based on the ratio of the US property subject to estate tax, divided by the total worldwide property of the decedent. Thus, the higher the ratio, the higher the tax credit, and the lower the estate tax.

The ratio can be increased by lowering the denominator of the ratio - i.e. lowering the value of the worldwide property. Thus, substantially reduced US estate tax may be achieved by reducing the Canadian property owned by the potential decedent, rather than reducing the US property.

For example, given that one spouse is expected to pass away shortly it may be possible for that spouse to give all or part of his/her Canadian assets to the other spouse. There may be no Canadian tax implications to such a transfer (please consult your Canadian tax advisor) and the US would normally have no tax jurisdiction over the gift of Canadian property by a nonresident alien of the US.

Example: Max and Eileen are married nonresident aliens of the US, resident in Canada. They jointly own a US residence valued at US $1 million, for which all the purchase funds were provided by Max. Max has no debt and owns Canadian assets valued at Cdn $10 million (US $8.9 million) for which he provided all the purchase funds. Thus Max has worldwide assets of US $9.9 million. Some of these assets are solely owned and some are jointly owned with Eileen.

Absent any other action or facts, Max is exposed to the following US federal estate tax in 2006:

Tentative federal estate tax on $1 million		$345,800
Potential unified tax credit	(approx)	(78,869)
Potential marital tax credit	(approx)	(78,869)
Potential US estate tax	(approx)	$188,062

Alternatively, if Max were to transfer Cdn $6.5 million (US $5.785 million) of his Canadian property to Eileen, Max would be

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exposed to US estate tax as follows (absent any other action or facts):

Tentative federal estate tax on $1 million		$345,800
Potential unified tax credit	(approx)	(189,745)
Potential marital tax credit	(approx)	(156,055)
Potential US estate tax	(approx)	None

Thus the estate tax of $188,062 might be completely eliminated if Max gives a portion of his Canadian property to his wife before death. But please consult your Canadian tax advisor before taking any action.

Caution

Before taking any action, a computation should be undertaken to determine if (under the tax treaty) the US estate tax would be creditable to a significant extent against any Canadian income tax that would be payable on an immediate sale of the property after the death. In that case, payment of the US estate tax (i.e. maintaining the status quo) may be a better alternative than transferring the property.

US CITIZENS & GREEN CARD HOLDERS OWNING MUTUAL FUNDS & "INCOME TRUSTS"

US citizens and US residents (including green card holders living in Canada) that own Canadian (or other non-US) mutual funds and/or "income trusts" must beware US reporting rules – some with big penalties for noncompliance.

The applicable US tax rules depend upon whether your investment is:

1) An "income trust", or a mutual fund that is organized (i.e. "set up" or "structured") as a trust, or

2) A mutual fund that is organized as a corporation.

You or your financial advisor may have to review the prospectus of a mutual fund to determine whether the mutual fund is organized as a trust, or a corporation.

"Income Trusts", and Mutual Funds Organized as Trusts

The US tax code generally requires a "US person" to file IRS Form 3520 and/or 3520-A by a due date if there is a specified transfer to, distribution from, or ownership interest in, a foreign (non-US) trust. See Internal Revenue Code Section ("IRC") 6048.

IRS Form 3520 -

1) Transfers and distributions. The penalty for failure to timely file Form 3520, Part I and/or Part III, to report transfers to your investment, or distributions received from your investment, is generally 35% of the value transferred, or distribution received.

There are exceptions including, in general, a "fair market value" transfer to a trust. Thus, an initial investment in a mutual fund or "income trust" would not normally require the investment to be reported on Form 3520. (But subsequent distributions must be reported, and see #2) Ownership" next).

Although RRSPs and RRIFs are "foreign trusts" they are specifically exempt from this requirement provided other rules are followed. (See IRS Form 8891).

2) Ownership. Failure to timely file Form 3520, Part II, to report your ownership interest in the foreign mutual fund or "income trust" may subject you to a penalty of 5% of the value of your investment. Thus, although your initial investment in the mutual fund or "income trust" may not require disclosure, a filing of Form 3520 may still be required in the year of your investment in order to report your ownership interest.

Again, no reporting is required for RRSPs and RRIFs provided other rules are followed.

The due date for Form 3520 is generally the due date of your US income tax return.

IRS Form 3520-A -

IRS Form 3520-A must be timely-filed to report your ownership of the investment. The mutual fund or the "income trust" itself is required to file the Form and to provide you with a related "Grantor Trust Owner Statement" and "Grantor Trust Beneficiary Statement" that you are required to attach to your Form 3520 (above). The penalty for noncompliance is generally 5% of the value of your investment.

It is your responsibility to ensure the mutual fund or "income trust" files Form 3520-A and provides you with the Statements referred to above. But of course the mutual fund or "income trust" may not comply! In this case you are required to prepare, to the best of your ability, a "substitute Form 3520-A". (See Form 3520, Part II, lines 22 and 23).

Form 3520-A is particularly dangerous

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because the due date may be earlier than your tax return. The due date is the 15th day of the third month after the end of the trust's tax year - thus March 15th in many cases. A six-month extension of the time to file can be obtained by filing IRS Form 7004.

Form 3520-A is not required for RRSPs and RRIFs provided other rules are followed. (See IRS Form 8891).

Mutual Funds Organized as Corporations

If you own shares in a Canadian or other non-US mutual fund that is organized as a corporation the IRS requires you to file IRS Form 8621 if you receive a dividend from the mutual fund, or you sell it. There does not appear to be a penalty for failure to file the Form, but the Form is used to make the special US tax computation that is required if you receive a dividend or sell the shares.

NONRESIDENT ALIENS & US CITIZENS - DEDUCTING MORTGAGE LOAN COSTS

If you acquire a US mortgage on your US property you may incur costs for loan origination fees or "points", commitment fees, appraisal fees, credit reports, surveys, lawyers' fees, and mortgage brokers' fees. These are all expenses that are related to the acquisition of the loan (rather than the property). Therefore they are not part of your cost (adjusted basis) of the property.

The tax treatment of these expenses for nonresident aliens depends upon whether the mortgage is obtained in connection with:

1) Business or rental property, or

2) Personal use property.

Business or Rental Property

In this case the expenses are considered capital expenditures and they are deducted (amortized) over the period of the loan.

Sale of the Property - Any unamortized fees and expenses at the time of sale of the property can be deducted in that year.

Prepayment of the Mortgage - If you prepay the mortgage, the unamortized fees and expenses are deducted in that year.

Refinancing of the Mortgage - In cases where you refinance the mortgage with a new lender, the unamortized fees and expenses can be deducted in that year. However if the mortgage is refinanced with the same lender, the unamortized fees and expenses are deductible over the term of the new mortgage.

In all cases, the amount of the current deduction may also be subject to other rules such as the rules for passive activity losses.

Personal Use Property

Generally, when the loan is incurred for personal purposes the loan costs are nondeductible, nonamortizable expenditures. An exception may apply for origination fees or "points" when incurred by a cash basis individual to purchase or improve a "principal residence" (as determined under US tax law). Subject to "Special Rules for Nonresident Aliens" (see below) these "points" for a "principal residence" are deductible if they are:

1) Designated as such on the "HUD-1" statement (i.e. the settlement statement),

2) Computed as a percentage of the amount borrowed,

3) Charged under established business practices in that area,

4) Paid in connection with the acquisition of the principal residence of the taxpayer and secured by that residence (to the extent the loan can be treated as "acquisition indebtedness"), and

5) Paid directly the taxpayer. This can include amounts paid as a down payment, escrow deposit or earnest money deposit.

Whether a mortgage loan is considered to be business, nonbusiness, or personal depends on the use of the proceeds, not the character of the property. (US v. Wharton, 207 F. 2nd 526 (1953)).

Special Rules for Nonresident Aliens - Nonresident aliens are only permitted to deduct expenses that are "effectively connected with a US trade or business" (which includes certain rental property).

Hence the origination fees or "points" incurred for a mortgage on a personal use residence are not deductible by a nonresident alien unless the proceeds are used for business or rental property and the amount is deductible under those separate rules.

US CITIZENS & RESIDENTS WITH CANADIAN HOLDING COMPANIES - BEWARE CAPITAL GAINS

Readers are aware, a US citizen or resident (including a green card holder living in Canada) that owns a private Canadian corpo-

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ration is subject to the "controlled foreign corporation" ("CFC") rules as set out in the Internal Revenue Code ("IRC").

Among other circumstances, these CFC rules may require you to pay US tax personally on certain gains that occur inside your Canadian corporation even when the proceeds are not paid to you. (IRC 954(c)((1)(B)). This may occur for example, if the net gains exceed 5% of the corporation's gross income. (IRC 954(b)(3)(A)).

Further, your US tax rate could be as high as 35% federally, instead of the potential 15% long term capital gains tax rate that may have been available if you had owned the asset personally.

Among other circumstances, these rules may apply to you if your Canadian corporation sells:

1) Property of a type that gives rise to dividends, interest, royalties, rents and annuities, (for example, stocks and bonds),

2) An interest in a trust, partnership or REMIC, and/or

3) Property that does not give rise to any income (for example a personal residence, or vacant land that is not used in business). (IRC 954(c)(1)(B)).

The rules may also apply if your corporation has a foreign currency gain. (IRC 954(c)(1)D)).

Exceptions

Gains from the following property are excepted from this rule - i.e. the gain is not taxed directly to you personally:

1) Certain dealer property,

2) Certain inventory,

3) Certain property that gives rise to rents and royalties derived from an unrelated person in the active conduct of a trade or business,

4) Certain related party transactions, - see Code Section 954(c)(3), and

5) Property used in the corporation's trade or business (Reg. 1.954-2(e)(-3)).

Thus, for example, the rules may not apply to tax you personally on corporate capital gains arising from the sale of real estate or equipment used in your Canadian corporation's business, or gains arising from the sale of your corporation's rental real estate in Canada if an active trade or business exists.

REVIEW OF US TAX WITHHOLDING ON REALTY SALES - (THE "FIRPTA" RULES)

The US imposes a withholding tax at the time of sale when a nonresident alien or foreign entity sells US real estate. The tax withheld is simply a prepayment of whatever US tax you actually owe on the sale. Various exemptions and special rules exist. For example there is an exemption if the selling price does not exceed $300,000 and the property will be "used as a residence" by the buyer. Please see Exhibit 1.

"Used As a Residence"

The expression "used as a residence" by the buyer means the buyer and his/her family have definite plans to reside at the property at least 50% of the time the property will be used by any persons during each of the first two 12-month periods following the date of sale.

US CITIZENS & NONRESIDENT ALIENS HAVING CORPORATIONS THAT PROVIDE "SERVICES"

The expressions "personal service contracts", "foreign base company services income", "personal service corporation", (sometimes referred to as a "professional service corporation" when the owner/employees are "professionals") and "*qualified* personal service corporation" are all referred to in the US tax code and/or regulations.

Each of these four concepts has a different meaning and different tax implication - usually with potentially unfortunate results. Nonresident aliens are subject to some of the rules. US citizens and US residents are generally subject to all of them.

US CITIZENS & RESIDENTS (INCLUDING GREEN CARD HOLDERS LIVING IN CANADA)

If you are a US citizen or US resident (including a green card holder living in Canada) the following rules apply:

1. Personal Service Contracts

A very recent addition to the US Internal Revenue Code may trigger an unpleasant surprise for the unwary. This provision may apply to you if you have a Canadian corporation that enters into a contract to furnish personal services if:

Some person other than the corporation has the right to designate the individual who is to perform the services, or

The individual who is to perform the services is designated in the contract.

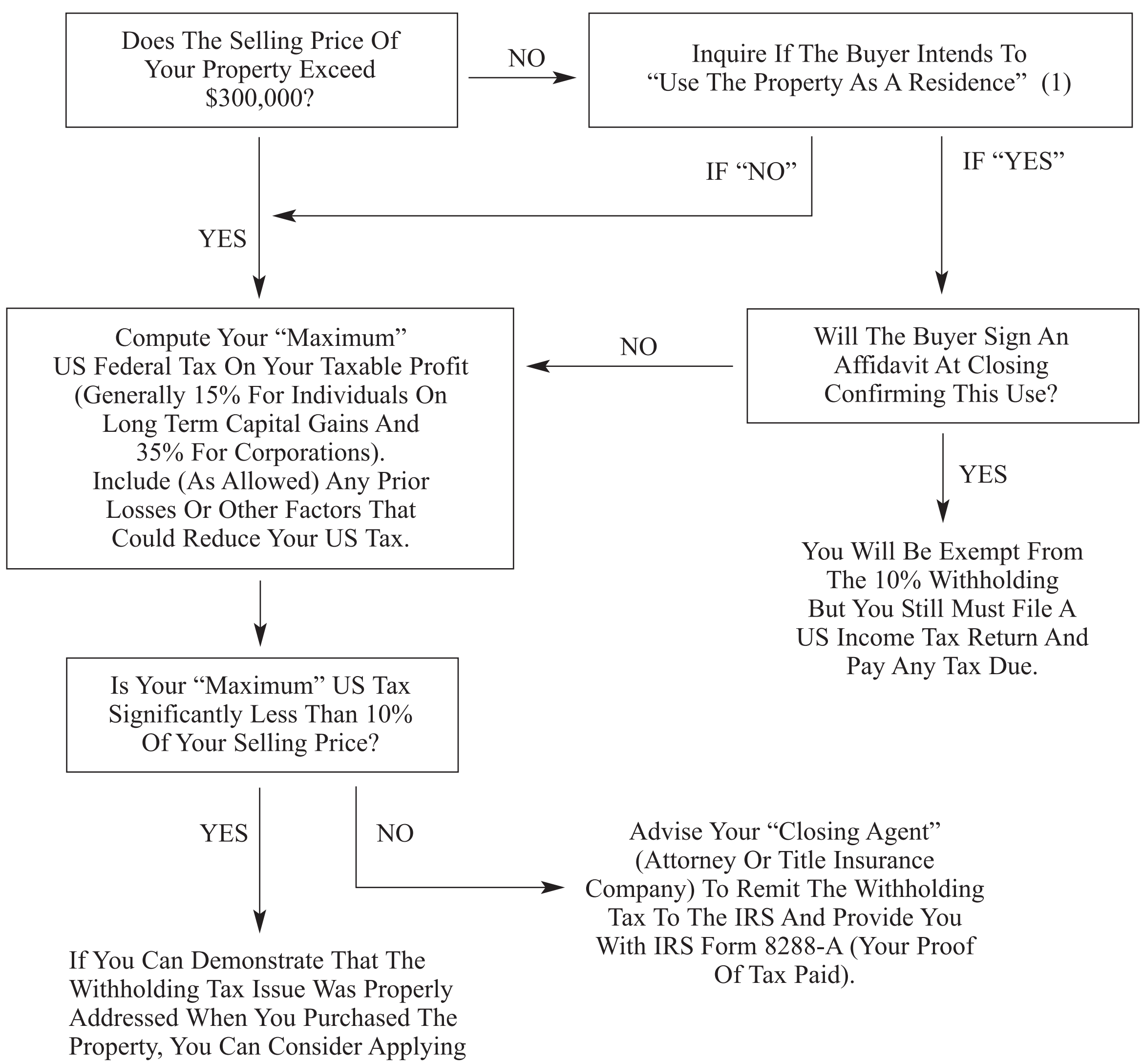
If you have a non-US corporation with such a contract you may be required to include the income on your personal US income tax return if the amount exceeds a certain threshold, even if it is not distributed to you. (See IRC 954(c)(1)(I)) and 954(b)(3)(A)).

2. Foreign Base Company Services Income

As in the case of "personal service contracts", if you have a Canadian corporation that receives "foreign base company services

EXHIBIT 1

US Withholding Tax On Nonresident Alien's Sale Of US Real Estate*



*Similar Rules Apply To A Sale By A Canadian Corporation.

(1) Please See Related Article For Definition Of "Used As A Residence." (Page 7)

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income" you may be required to include the income on your personal US income tax return if the amount exceeds a certain threshold. (IRC 954(e) and 954(b)(3)(A)).

"Foreign base company services income" means income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services which:

1) are performed for or on behalf of a related person, and

2) are performed outside the country under the laws of which the corporation is created or organized.

Thus, for example, if your Canadian corporation performs such services in the United States for it's US subsidiary, you may be personally subject to US tax on the income. Similarly, the rule may apply if your Canadian corporation performs services in the United States to a third party "*on behalf of*" a subsidiary or affiliate of your Canadian corporation. (For exceptions, see IRC 954(e)(2)).

3. Personal Service Corporations

The expressions "personal service corporation" and "professional service corporation" ("PSC") are apparently used generically in tax terminology to describe a corporation whose business is to provide the personal services of the shareholder/employee. This may occur where athletes and others form a corporation through which they offer their services.

A possible IRS attack against some generic PSCs may involve the use of Code Section 482 to allocate income (and tax) to the shareholders rather than the corporations and/or to claim the corporations are shams. (For example, see below, under "**NONRESIDENT ALIENS**").

However the expressions "personal service corporation" and "qualified personal service corporation" also have specific and different meanings under Code Sections 269A and 448(d)(2) respectively. Please see Exhibit 2.

Personal Service Corporation under 269A - Code Section 269A provides generally that if:

1) Substantially all of the services of the corporation are performed for, (or on behalf of) one other entity, and

2) There is a principal purpose of avoiding tax, then the IRS can potentially re-allocate income, etc., between the corporation and its shareholders. For Section 269A, a personal service corporation means a corporation, the principal activity of which is the performance of services, and such services are substantially performed by employee-owners.

If some profit remains in the corporation after this re-allocation, it will be taxed federally at a flat 35% rate (rather than graduated rates) if it is a "qualified personal service corporation".

4. "Qualified" Personal Service Corporations

A qualified personal service corporation is any corporation:

i) Substantially all of the activities of which involve services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

ii) Substantially all of the stock of which (by value) is held directly or indirectly by employees performing services for the corporation, or certain retired employees, estates, or estate beneficiaries. Please see Exhibit 2.

NONRESIDENT ALIENS

The above-described US tax code provisions for "personal service contracts" and "foreign base company services income" apply only to US citizens and residents (including green card holders living in Canada).

However the provisions for "personal service corporations" and "qualified personal service corporations" could also apply to nonresident aliens that perform services in the United States.

Nonresident alien entertainers or athletes (for example) that perform in the US and are compensated via their Canadian corporation may have the IRS ignore the separate existence of the corporation and tax the US income directly to the shareholder.

In Revenue Ruling 74-330 (addressing nonresident alien situations) the IRS analyzed several different situations involving personal service corporations. The Ruling describes circumstances in which the IRS would respect the employer/employee relationship between the corporation and its shareholder and other circumstances in which it would tax all or part of the corporation's income directly to the shareholder.

See also IRS Technical Advice Memorandum ("TAM") 8625003 involving a professional hockey player with a PSC.

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REVIEW OF "US RESIDENCY" RULES (FOR INCOME TAX)

Most readers are familiar with the US tax rules that determine whether you will be considered a US resident for US income tax. This occurs if you meet either:

1) The "green card" test, or

2) The "substantial presence" test and do not file a valid Closer Connection Exception Statement (IRS Form 8840). (See "***Form 8840***" below).

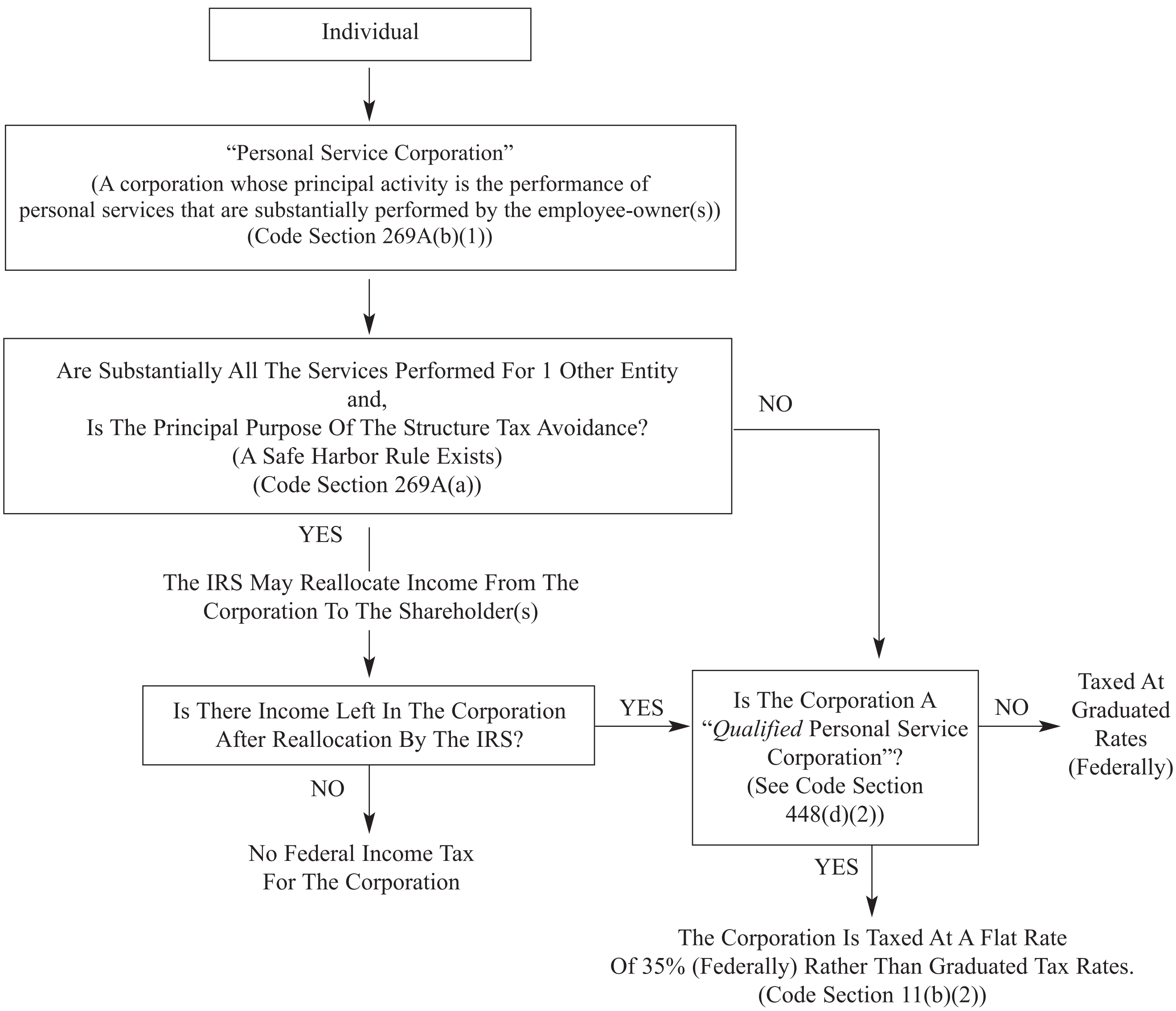
The US residency rules for US income tax are summarized in general in Exhibit 3.

These rules do not apply to US citizens.

If you meet ("flunk") either of the above tests you might still qualify to file your US income tax return, and compute your US income tax liability, as a nonresident of the US under Article IV of the tax treaty. Please

EXHIBIT 2

Rules For "Personal Service Corporations" Under Sections 269A, 448(d)(2) And 11(b)(2)



In Either Case,
The exemption for accumulated earnings tax is reduced to $150,000 if the corporation performs services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

Note: A different definition of a PSC may apply in other circumstances - e.g. the selection of a tax year, and many exceptions apply.

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see the article "***FUTURE TROUBLE FOR NON-RESIDENT ALIENS OVER TIMELY-FILING OF TREATY RESIDENCY CLAIMS?***"

However despite such a claim you will still remain a US resident for other aspects of the US tax law, including certain information reporting. Please see some examples of the required information reporting in the article "***NONRESIDENT ALIENS - WHY FILE THE CLOSER*** **CONNECTION** ***STATEMENT (FORM 8840)?***"

Form 8840

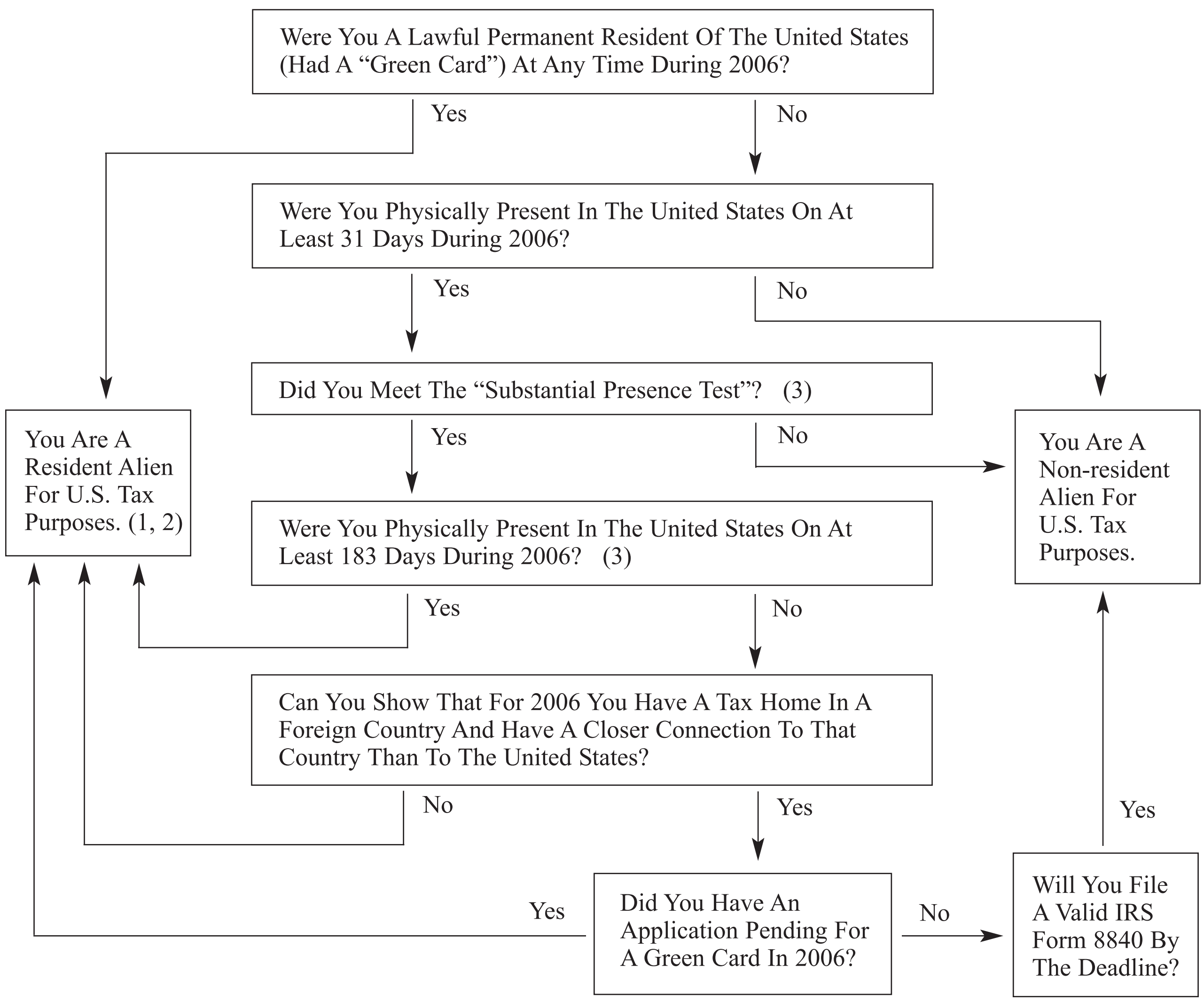
You may be a US resident for US income tax if you meet the "substantial presence" test and do not file a valid IRS Form 8840.

Please refer to Worksheet 1 to evaluate whether you met the substantial presence test for 2006. Even if you met the substantial presence test for 2006 you will not be considered a US resident for 2006 if you file a valid Form 8840 by the deadline.

The deadline is generally the 15th day of the 6th month after the end of your tax year (the 15th day of the 4th month if you have wages subject to US withholding). Thus it is normally June 15th unless you file for a six–month extension with IRS Form 4868.

EXHIBIT 3

Start Here To Determine Your Status For 2006



1 If This Is Your First Or Last Year Of Residency, You May Have A Dual Status For The Year.

2 In Some Circumstances You May Still Be Taxed As A Nonresident Alien Under The Income Tax Treaty.

3 You May Be Able To Exclude Some Days You Were Present. See Worksheet 1 On Page 12

See IRS Pub. 519

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Form 8840 has been revised for 2006 and you are no longer required to list any:

a) Social, cultural, religious and political organizations in which you participated, or

b) Charitable organizations to which you contributed.

Worksheet 1

Year 2006 Substantial Presence Test Worksheet

(Use this worksheet to determine if you met the substantial presence test for 2006)

Number of days in the US in 2006	_________
1/3 the number of days in the US in 2005	_________
1/6 the number of days in the US in 2004	_________
Total	_________

If the total equals or exceeds 183 days and you spent more than 30 days in the US in 2006 you met the substantial presence test for 2006. In counting days, you may be able to exclude days you were present as an "exempt person", days you could not leave because of a medical condition that arose in the United States, or certain days commuting to work or traveling in transit to another country. In some cases you must make a US filing to obtain the exclusion.

US WAGE WITHHOLDING FOR CANADIAN EMPLOYERS IN CROSS BORDER CIRCUMSTANCES

In addressing the US wage withholding responsibilities of "employers", the US Internal Revenue Code generally does not distinguish between domestic and foreign employers. Thus, there is no general exemption from US wage withholding for Canadian and other non-US employers. Nonetheless the rules vary depending upon whether:

1) The relevant work is performed in Canada or the US, and

2) The employee is a US citizen or nonresident alien.

Employee's Work is Performed in Canada

US Citizens - Generally the US tax code requires Canadian employers to withhold US tax on wages paid to certain Canadian residents that are US citizens, even for work performed in Canada. (See Code Section 3402 where the definition of "employer" is not restricted to a US employer). However various exemptions apply under Section 3401(a) including circumstances where:

1) It is reasonable to believe the remuneration will be excluded from tax under Code Section 911 (the "foreign earned income exclusion", which is $82,400 for 2006), (IRC 3401(a)(8)A)(i)), or

2) The employer is required to withhold income tax under Canada's tax laws. (IRC 3401(a)(8)(A)(ii).

(See also IRC 3402(m)).

Nonresident Aliens - If the employee is a nonresident alien of the United States the employer is exempt from US wage withholding provided the work is not performed in the United States. (Regulation 31.3401(a)(6)-1(b)).

Employee's Work is Performed in the United States

Perhaps surprisingly, if a Canadian employer sends a Canadian resident employee to work temporarily in the US, the presence of a Canadian employee in the US may trigger US tax obligations for both the employer and the employee.

A special exemption exists for certain residents of Canada and Mexico who enter and leave the US at frequent intervals, such as:

1) Certain individuals performing duties in the transportation business involving a railroad, bus, truck, ferry, steamboat or aircraft, (Reg. 31.3401(a)(6)-1(c)(1)), and

2) Certain individuals performing duties in connection with construction, etc, that traverses the border. (Reg. 31.3401(a)(6)-1(c)(2)).

The employer's obligations may arise under Code Section 3402 (the wage withholding rules) or Section 1441 (the withholding rules on foreign payments generally). However Section 1441 does not apply if Section 3402 applies. Thus Section 1441 generally does not apply to wages, although it may apply to payments made to self-employed individuals that are not US citizens. (Regulation 1.1441-4(b)(1)(i) and (ii)).

Rules for the Employer

Under Internal Revenue Code Section 3402 any employer is generally required to withhold US federal income tax on an employee that the employer sends to work in

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the United States. This may be required even if the employee is clearly still a resident of Canada and not a resident of the US. The withholding applies with respect to the portion of the employee's work performed in the US (i.e. the US source income as described in Code Section 861).

US Citizens - If the Canadian employee is a US citizen, the employer may be exempt from withholding under Section 3401(a)(8) mentioned above (e.g. Canadian withholding is required under Canadian tax law). Other exemptions may also apply under Section 3402.

Nonresident Aliens - Under Code Section 3402 the employer is generally required to withhold tax on wages paid to nonresident aliens to the extent the wages are US source income - i.e. to the extent the wages are paid for services performed in the United States. (See Regulation 31.3401(a)(6)-1(b)) and Code Section 861(a)(3)). Withholding is at graduated tax rates. However the tax treaty permits a reduction in the withholding to 10% on the first $5,000 of wages.

State and local withholding tax obligations may also exist.

Rules for the Employee

US Citizens - Of course a US citizen resident in Canada must file a US federal income tax return annually, provided the income is above the filing threshold. To the extent the wages earned are "US source", the US will tend to get the "first" tax on those wages, with Canada obligated to give a foreign tax credit for all or part of the US tax.

Nonresident Aliens - Generally, a Canadian employee of a Canadian business who works temporarily in the United States is required to file a US federal income tax return with respect to the portion of wages earned in the United States. Again this applies even if the employee continues to be a resident of Canada and not a resident of the United States. However two potential exemptions exist:

1) Tax Code Exemption - The employee is exempt from US federal income tax, provided:

a) the employer is an non-US employer,

b) the employee is present in the US for 90 days or less during the year, and

c) the compensation for the services does not exceed $3,000. (IRC 864).

2) Tax Treaty Exemption - The employee is also exempt from US income tax if:

a) the remuneration does not exceed $10,000, or

b) the employee is not present in the US more than 183 days during the year, and the remuneration is not borne by a US "permanent establishment" ("PE") of the employer. (Treaty Article XV).

Thus, a determination of whether the employer has a PE in the US can be important to both the employer and the employee. Please see the article "***REVIEW OF THE CONCEPT OF PERMANENT ESTABLISHMENT***".

Individual States will likely not respect the tax treaty exemption, and thus State income tax requirements could apply to both the employer and the employee even if they are exempt from US federal income tax requirements.

WILL YOU BE PERMITTED TO ENTER THE US AFTER DECEMBER, 2006?

US immigration legislation enacted in 2004 requires all travelers (including US citizens) to present a passport, or other documents that denote citizenship, when entering the United States after a certain date. (Apparently a birth certificate will not be sufficient). The Act was amended in 2006 and the Government has issued the "*Western Hemisphere Travel Initiative*" ("WHTI") as its proposed plan to implement this law.

As of January 8, 2007

As of January 8, 2007, all persons, (nonresident aliens and US citizens alike) traveling *by air* between the US and Canada, Mexico, Central and South America, the Caribbean and Bermuda will be required to present a valid passport, AIR NEXUS card, or US Coast Guard Merchant Marine Document, to enter the United States.

January 1, 2008

As early as January 1, 2008, all persons, (nonresident aliens and US citizens alike) traveling by *land or sea* between the US and Canada, Mexico, Central and South America, the Caribbean and Bermuda may be required to present a valid passport, or other documents as determined by the US Department

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of Homeland Security, in order to enter the United States.

Special Rules for US Citizens

The government has proposed providing for a credit card-like "passport card" that could be issued to US citizens (upon application) and used instead of a formal passport for land and sea travel (only), between the US and Canada, Mexico, the Caribbean and Bermuda. It is uncertain when these cards will first be available.

A US citizen will be permitted to hold both a normal passport and a passport card. The card would be issued for a 10 year period and would be issued on the same basis and with the same documentation as that required for a normal passport. It would contain a facial image, name, date and place of birth, card number, and expiry date on one side, and a machine readable zone on the other side. For updated information you can go to: **http://travel.state.gov/travel/cbpmc/cbpmc_2223.html.**

FUTURE TROUBLE FOR NONRESIDENT ALIENS OVER TIMELY-FILING OF TREATY RESIDENCY CLAIMS?

The articles "***REVIEW OF US RESIDENCY RULES FOR INCOME TAX***" and ***"NONRESIDENT ALIENS - WHY FILE THE CLOSER CONNECTION STATEMENT (FORM 8840)?"*** describe certain aspects of the US income tax rules addressing US "residency". Reference is made to Article IV of the tax treaty. That provision enables certain individuals to compute their US income tax liability "as if" they are nonresident aliens, even though they meet the residency rules and are treated as US residents for other purposes of the US income tax rules, such as reporting rules. (For example, the reporting rules for IRS Form 5471 and Treasury Form TD F 90-22.1 - both with big penalties for noncompliance.)

If either:

1) You meet the substantial presence test and do not qualify for the "closer connection exception", (Form 8840), or

2) You possess a green card, you might still be able to file your US income tax return as a nonresident alien if you meet the requirements. Under Regulation 301.7701(b)-7(b), one of the requirements is as follows:

*You must ''….(file) a (tax) return on Form 1040NR on or before the date prescribed by law (*emphasis added*) ….. for making an income tax return as a nonresident".*

The "date prescribed by law" is 5½ months after the end of your tax year (3½ months if you receive wages subject to US withholding). Thus the return is normally due June 15th unless extended for 6 months by filing IRS Form 4868.

Does this mean that if you do not file your 1040NR by that date your filing is late and your treaty claim will be denied and you will be taxed as a resident of the United States?

Our conversations with the IRS in Washington have failed to provide a definitive answer. One can see the Government's logic for such a deadline. Absent a deadline, you are free to defer filing a tax return until questioned by the IRS. Hence you may never file, you will remain "below the radar", and the IRS will never have its opportunity to evaluate the validity of your claim. (But even if you never file, you have the same potentially unfortunate consequences as described in the article "***NONRESIDENT ALIENS - WHY FILE THE CLOSER CONNECTION STATEMENT (FORM 8840)?***").

There is some precedent for predicting that the IRS may, at some point in the future, attempt to enforce the filing deadline. Readers are aware that several years ago the IRS issued "timely-filing" regulations, requiring nonresident aliens to file any required US income tax return by a deadline. Otherwise the nonresident alien would be denied the right to deduct expenses. As above, the Government's logic was, in part, that without such a deadline you can remain "below the radar", with an open-ended option to file, (or not file), a tax return at any time in the future.

We recently reported that the US tax court declared those regulations invalid because the provision was not specifically incorporated in the tax code itself. However, many commentators believe that this provision (regarding expenses) is sufficiently important to the IRS that it will attempt to have the Congress amend the tax code to formally include a timely-filing deadline.

Or, even simpler, the Congress could add a provision to the tax code authorizing the IRS to issue regulations governing timely-filing requirements with respect to both expenses and treaty residency claims.

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Regulations issued under such authority would be "legislative regulations" (as distinguished from "interpretive regulations"). Legislative regulations generally have the force of law, as if they are contained in the Internal Revenue Code itself!

Note that such a "legislative regulation" currently governs the filing of IRS Form 8840 and requires it to be filed by a deadline. See Code Section 7701(b)(8) and Reg. 301.7701(b)-8(d).

Thus there is some possibility your future treaty residency claim could be denied if it is not filed by the deadline.

WHO'S THAT KNOCKING AT MY DOOR?

By Former IRS Attorney Robert Blumenfeld, Esq. Tel: 954-384-4060, or email rblumenf@aol.com.

Those of us who have frequent dealings with the Internal Revenue Service realize there are two types of IRS individuals with whom the public generally deals;

1) Revenue agents who determine how much tax you owe, and

2) Revenue officers who collect the money from you if you don't promptly remit a check to the United States Treasury Department.

Now, the Internal Revenue Service has decided to privatize part of collection process. This means that in certain cases, it will not be an IRS employee but the employee of a private collection company who is trying to collect your delinquent taxes!

This situation came about because the IRS does not have sufficient staffing in its Collection Division to collect all the money that taxpayers owe. If you look at the numbers, privatization is really a dreadful waste of money. For each dollar the IRS collects, it currently expends approximately three cents. On the other hand these collection agencies are being paid approximately $.22 to $.24 on the dollar to collect the money. Why, you might ask, is this being done?

The Internal Revenue Service has asked Congress on any number of occasions to increase its staff. Former Commissioner Rossotti, a computer expert, so testified before Congress. Congressmen however, feeling that they might get a backlash from their constituents if the IRS became more efficient, have generally denied additional funding to the Internal Revenue Service. Thus, in order to close the gap between money owed to the IRS and actual collections, the IRS has sought to implement this by means of privatization. It is projected that these private collectors will bring in about $1.4 billion in the next 10 years, at a cost of roughly $330 million. If the IRS hired new employees to do the same thing, the cost would be roughly $42 million. Therefore the government might lose about $288 million through privatization!

The IRS, for its part, is trying to curb the enthusiasm of private collectors whose income is predicated on collecting money from taxpayers. First, they will only be utilized to collect money from those who owe less than $25,000 to the Internal Revenue Service. Second, before implementing this, the Internal Revenue Service will give the "chosen" taxpayers written notification of this privatization, and give the taxpayer an option of working directly with IRS employees. These firms are bound by the Fair Debt Collection Practices Act, and the Internal Revenue Service has in place certain safeguards to try to protect the taxpayers; monitoring telephone conversations, surveys to taxpayers to determine taxpayer satisfaction, review of audit collection records, and thorough investigation of backgrounds of collection employees along with direct training by IRS personnel.

In spite of this I believe the taxpayers are placed at a higher risk with this new system. IRS employees always instruct taxpayers to get current on their taxes first in order to minimize penalties. Private collectors have no incentive to do this; in fact, since they are paid a percentage of the "swag", it may behoove them to instruct the taxpayer to pay penalties and interest first, enabling the liability to increase.

We would hope that this situation does not create too many problems for taxpayers, but I fear for the worst. It opens up a whole new series of possibilities of scams by unscrupulous individuals. One precaution that each of you should take is that if you work with one of these private debt collectors, ALWAYS make out the check to the United States Treasury Department regardless of what the collector tells you. Good luck!

The author spent 32 years as a senior attorney with the Internal Revenue Service, most of it in Washington, DC. He can be contacted at 954-384-4060 or rblumenf@aol.com.

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NONRESIDENT ALIENS - WHY FILE THE CLOSER CONNECTION STATEMENT (FORM 8840)?

Are Canadian snowbirds becoming too nonchalant about filing IRS Form 8840 ("Closer Connection Exception Statement")? Since there has been no "bad publicity" about "non-filers", have some individuals become complacent and stopped filing?

Why should you bother to continue to file if you have friends that don't file and nothing "bad" has happened to them so far? Possible answer: The filing is simple, and a valid filing makes you "safe". (Safe from what?)

If you meet the "substantial presence test" and do not file, you are a US resident. Many US surprises are then potentially present.

Examples are:

1) You may be required to file US Treasury Form TD F 90-22.1 ("Report on Foreign Bank and Financial Accounts"). Incredibly, there is a potential criminal penalty for failure to comply. The penalty could be as high as:

i) $500,000, and

ii) 10 years in jail.

(See instructions to Form TD F 90-22.12, and 31 US Code 5322(b), and 18 US Code 1001).

We are not yet aware of this penalty being imposed on a Canadian that is not a US citizen, green card holder, or other ("normal") US resident. However it is commonly a threat to US citizens, green card holders and other ("normal") US residents. Please see the article "***US CITIZENS & US RESIDENTS -BEWARE BANK ACCOUNTS OUTSIDE THE US***" by Robert Blumenfeld, Esq. in the Fall, 2005, issue of the Taxletter. (Also please see the current article by Mr. Blumenfeld "***WHO'S THAT KNOCKING AT MY DOOR***").

2) You may also be subject to significant penalties for failure to file IRS Form 3520 with respect to certain Canadian mutual funds or Canadian "income trusts" that you own. The penalty may be 35% of the payments to you, or 5% of the value of your investment. Please see the article "***US CITIZENS & GREEN CARD HOLDERS OWNING MUTUAL FUNDS & "INCOME TRUSTS***".

3) If you own a private Canadian "holding" corporation, you may be taxed in the United States on dividends, interest, rents and capital gains inside the corporation, even if they are not paid to you. Please see the article "***US CITIZENS & RESIDENTS WITH CANADIAN HOLDING COMPANIES – BEWARE CAPTAL GAINS***".

4) You may be subject to a penalty of $10,000 if you own a private Canadian corporation and fail to timely file IRS Form 5471.

Numerous other examples exist. Individuals may fear that filing Form 8840 will place them "in the US tax system". However if the filing is valid, and no tax is avoided, it appears the risks of not filing are greater than the risks of filing.

HOUSING EXCLUSION RULES LIBERALIZED

In the Summer, 2006, issue of the Taxletter we summarized the new rules for the "Foreign Housing Cost Exclusion". Possibly as a result of criticism from the public, the IRS has relaxed the limitations on the exclusion for residents of certain areas.

The general rule limits "housing expenses" to $24,720. However for 2006 the IRS has increased the limit for various "high cost" areas. See IRS Notice 2006-87.

There are increases in the limit for several Canadian cities including the following: Vancouver ($39,000), Ottawa ($39,200), Toronto ($41,500) and Montreal ($50,700).

"Housing expenses" must be reduced by the "base housing amount" ($13,184 for 2006) to determine the actual housing exclusion.

US CITIZENS & RESIDENTS WITH RRSPs ANDS RRIFs - SECTION 72(w) MAKES CHANGES

Section 72 of the US Internal Revenue Code provides the rules for computing the taxable part of annuity payments you receive. Simplistically, if you contributed after- tax dollars to an annuity, a portion of the annuity payments you receive are a tax-free return of capital to you.

The US taxation of payments received from non-US pensions is also determined under Section 72, as is the US taxation of payments received from RRSPs and RRIFs. (See IRS Revenue Procedure 2002-23, Section 5).

Before 2004 it was therefore considered that certain payments from RRSPs and RRIFs

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could constitute a tax-free return of capital for:

1) Individuals that had been nonresident aliens at the time of the contributions and/or earnings inside the plan, and

2) US citizens and US residents that had reported the contributions, and/or earnings inside the plan, as taxable income on their US income tax returns in the year of the transaction.

The above conclusions stemmed from the fact the RRSP or RRIF did not qualify as a valid tax deferral vehicle under US pension tax law, and therefore the above taxpayer/contributor was considered to have "after-tax" dollars (i.e. "basis") in the RRSP or RRIF plan. Thus, certain payments from the plan could constitute a tax-free return of capital.

However in October, 2004, the US enacted new legislation that added Subsection 72(w) to Section 72 of the Internal Revenue Code. Expressed simplistically, 72(w) denies basis (after-tax dollars) for the funds you have in an RRSP or RRIF unless the contributions or earnings, as the case may be, were subject to tax in Canada or the US, or another country.

Therefore, generally, payments from RRSPs and RRIFs are fully included in US taxable income except to the extent the contributions, or earnings inside the plan, as the case may be, were subject to tax in Canada, the US, or another country.

Technically, there is an exception to the denial of basis, for the contribution portion, if the compensation to which the contribution related would not have been subject to tax if it had been paid in cash when earned. (IRC 72(w)(2)(B)).

Applicability to Foreign Pensions

The rules described above also apply to the US taxation of foreign pensions received by US citizens and residents.

Again, an exception applies to the contribution portion, if the compensation to which the contribution related would not have been subject to tax if it had been paid in cash when earned. (IRC 72(w)(2)(B)). Thus it appears, for example, that certain Canadian international civil servants that worked for the United Nations and were exempt from tax on their UN salary would continue to have some basis and therefore be exempt from US tax on part of their pension payment.

REVIEW OF THE CONCEPT OF "PERMANENT ESTABLISHMENT"

Readers are aware, the tax concepts of "nexus" and "permanent establishment" are important for a Canadian business that has US activity and/or US customers, because they can determine whether the Canadian business has US State or federal tax responsibilities, respectively. "Nexus" will be summarized and updated again in the next Taxletter.

Canadian enterprises that are "engaged in business in the US" must file US federal income tax returns. There is no precise definition of being "engaged in business in the US". Any US activity or connection more than simply shipping product into the US via a common carrier may require an analysis of whether your enterprise could be considered engaged in US business. However you are aware there will be no US federal tax liability on income connected with your US business if, pursuant to Article VII of the tax treaty, your business does not have a US "permanent establishment". You must file a US income tax return to make this tax treaty claim.

Article V of the treaty states that the term "permanent establishment" ("PE") means "a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on". The article gives examples of circumstances that do constitute PEs and examples of other circumstances that do not. An important exemption for many Canadian businesses is a construction or installation project that lasts for 12 months or less. However please beware the "anytime" rule, mentioned below.

Two definitions that make it difficult to evaluate whether you have a PE are:

1) "Place of management", and

2) "Agent".

Place of Management

The treaty specifically states that a "place of management" constitutes a PE. This has caused confusion as to whether a "place of management" can exist in the absence of an office. For example can a place of management exist if an entrepreneur or executive operates from a temporary hotel room? Apparently some uncertainty exits. The commentary on the OECD model treaty suggests

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that a PE can exist via a place of management even when there is no office.

The US apparently believes (generally) that it is difficult to envision the circumstances under which there could be a place of management that does not have other attributes of a permanent establishment, especially in cases where the term "place of management" is not expressly stated in the treaty. However in the case of the Canada-US treaty the term "place of management" is specifically stated in the treaty as constituting a PE. Thus a US "place of management" may be a concern for Canadian businesses, and the concept may attract more publicity in the future.

Agents

The meaning of "agent", and the difference between dependent agents and independent agents, are other unclear areas of the tax law. A correct evaluation of which type you have (if any) can make a substantial difference in your US tax exposure.

Despite the lack of specific definitions, the US tax code and the treaty both attempt to distinguish between dependent agents and independent agents.

Dependent Agents - The expression used in the Canada-US tax treaty is actually broader than the term "dependent agent". The treaty states that "*a person acting in a Contracting State on behalf of a resident of the other Contracting State other than (certain independent agents) shall be deemed to be a permanent establishment in the first mentioned State if such person has, and habitually exercises in that State, an authority to conclude contracts in the name of the resident*". (Emphasis supplied).

Independent Agents - The treaty states that "*a resident of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided such persons are acting in the ordinary course of their business*".

So – what are the meanings of:

1) Dependent vs. independent,

2) "Authority to conclude contracts" and "Habitually exercises", and

3) "Ordinary course of their business"?

Dependent vs. Independent - Several factors may be evaluated to determine whether an agent is independent such as:

1) Control – the extent to which the agent operates on the basis of instructions from the Canadian business,

2) Business risk – economic risk – the extent to which the agent bears entrepreneurial or business risk,

3) Profits - whether or not the agent earns "arm's length" remuneration from the Canadian business, and

4) Exclusivity – whether the agent has an exclusive or nearly exclusive relationship with the Canadian business - i.e. the degree to which the agent has other customers.

"Authority to Conclude Contracts" And "Habitually Exercises" - To be a dependent agent, the agent must be able to conclude contracts on behalf of the Canadian business. This authority must cover contracts relating to the "core" business activities of the Canadian business. The agent will be considered to exercise its authority if it negotiates elements and details of a contract in a way binding on the enterprise, even if the contract is actually signed by another person in Canada.

Also, the agent must "habitually exercise" this authority. Whether the authority is "habitually exercised" depends on the facts and circumstances. However the agent would likely have to exercise the authority "repeatedly and not merely in isolated cases".

"Ordinary Course of Business" - There is no U.S. authority defining what it means to act "in the ordinary course" of business. However, for example, if a commission agent not only sells goods of your Canadian business in his own name, but also habitually acts as an agent for you having authority to conclude contracts for you, the latter activity would be acting outside the ordinary course of his own business as a commission agent.

Also, it can be argued the only way a commission agent can have an "ordinary" course of business is if he acts for several principals.

Beware the "Anytime" Rule!!

If your Canadian business has a PE in the US "at any time" during the tax year, it is considered to have a PE for the entire taxable year!

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In one court case, a Canadian resident conducted a business through a U.S. permanent establishment. In the middle of the tax year he moved, along with his business, to Switzerland, after which he continued to receive royalty income from United States sources but did not have a PE in the US.

Even though the Swiss-US treaty contained an exemption from tax on US royalty income based on their being no PE in the US, the US Tax court decided he was not exempt from US tax under Swiss-US treaty because he did have U.S. permanent establishment at some time during the taxable year, even though not at the time he received the royalties. (*Samann v. Comr 36 TC 1011, aff'd, 313 F. 2nd 461 (1963)).*

A combination of the concepts of "place of management" (mentioned above) and the "anytime" rule could provide unexpected future US tax surprises for some Canadian businesses.

US TAX "ID" NUMBERS FOR NONRESIDENT ALIENS ON US REAL ESTATE SALES

At the time of sale of US real estate by a nonresident alien, 10% of the selling price may be withheld from the sales proceeds and sent to the IRS as a prepayment of the nonresident alien's US income tax (capital gains tax) on the sale. This tax is sent to the IRS with two copies of IRS Form 8288-A. There are three variations of what can happen next, depending upon whether or not you have a US "taxpayer identification number". ("TIN").

For individuals, a TIN is generally either a US social security number ("SSN"), issued by the US Social Security Administration, or an "individual taxpayer identification number" ("ITIN") issued by the IRS. Nonresident aliens without visas enabling them to live or work in the US are generally ineligible for SSNs.

You Already Have a US tax ID Number

If you have a US taxpayer identification number it will be inserted on Form 8288-A before it is submitted to the IRS. Upon receipt of the two copies of Form 8288-A, the IRS will stamp one copy and return it to you as your receipt for the tax. You then attach a copy of it to your US income tax return that reports the sale, to get credit for that tax.

You Do Not Have a US tax ID Number

If you do not have a US taxpayer identification number at the time of sale you have two options:

1) Apply For a Number. Assuming you are ineligible for a SSN you can apply for an ITIN by attaching the application form (IRS Form W-7) to the documentation sent to the IRS with Form 8288-A. You cannot send a freestanding application (Form W-7) to the IRS in advance, in this case.

Be sure to also attach the appropriate documentation as set out in the instructions to W-7. Any certifications must be provided by either a US notary or an "Acceptance Agent".

When the IRS receives the combined package including the Form W-7 and 8288-A it will advise you of the ITIN it has assigned to you, and it will stamp one copy of Form 8288-A and return it to you as your receipt for the tax. As above, you then attach a copy of it to your US income tax return that reports the sale to get credit for the tax paid.

2. Do Not Apply for a Number. It is fairly routine for nonresident alien sellers not to apply for a number at the time Form 8288-A and the tax are remitted to the IRS. This often results because the nonresident alien seller, and even the closing agent, are unfamiliar with the procedure or because it is inconvenient under the circumstances.

If Form 8288-A and the tax are submitted without a number the IRS will process the tax payment and record it in your name. However instead of stamping one copy of Form 8288-A and returning it to you as your receipt for the tax the IRS will send you a letter stating:

"We are sending this letter to inform you that we are unable to mail your Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests (USRPI), because you did not supply us with your U.S. tax identification number (U.S. TIN).

Remember, the foreign transferor (seller) of the USRPI must have a U.S. ITIN in order to file their U.S. income tax return to claim credit for the income tax withheld from the sale of the USRPI. "

You need not be concerned about this letter, or the fact you do not receive back the stamped 8288-A. You can still file your US income tax return and obtain credit for the

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tax paid with Form 8288-A as long as you attach a copy of Form 8288-A provided to you by the closing agent. However you must apply for an ITIN with the tax return by attaching Form W-7 and the appropriate documents to the tax return.

TAX RETURN PREPARERS BEWARE - ACCURACY–RELATED PENALTY!

If you file a US tax return with an underpayment of tax, the US tax code contains potentially serious penalties for you if there is:

1) Negligence or disregard of rules or regulations, or

2) A substantial understatement of income tax, or

3) A substantial valuation misstatement concerning regular income taxes, or

4) A substantial estate or gift tax valuation understatement, or

5) A substantial overstatement of pension liabilities.

The regular penalty is potentially 20% of the underpayment of tax. (IRC 6662(a)). However the penalty may be as high as 40% of the underpayment for items 3), 4) and 5) above if there is a "gross valuation understatement". (IRC 6662(h)).

For a definition of when the penalty rises to 40% of the underpayment due to a gross valuation misstatement see IRC 6662 (h)(2)(A).

"Negligence" or "Disregard"

"Negligence" includes any failure to make a reasonable attempt to comply with any of the tax laws. "Disregard" includes any careless, reckless, or intentional disregard.

Substantial Underpayment of Income Tax

For taxpayers other than corporations a substantial underpayment occurs when the underpayment exceeds the greater of:

3) $5,000, or

4) 10% of the required tax.

For corporations, (other than S corporations and personal holding companies) a substantial underpayment occurs when the underpayment exceeds the lesser of:

a) 10% of the required tax (or, if greater, $10,000), or

b) $10 million.

The penalty may be reduced if:

1) There is substantial authority for the treatment , or

2) The treatment is disclosed and there is a reasonable basis for it.

Substantial Valuation Misstatement Concerning Regular Income Taxes

For this purpose, there is a substantial valuation misstatement if:

a) the value of any property (or its adjusted basis) is 150% or more of the "correct" amount, or

b) i) the price for any property, services, or use of any property between certain related parties is 200% more, (or 50% less) than the "correct " amount, or

ii) the transfer price adjustment (see IRC 6662(e)(3)) exceeds the lesser of 10% of gross receipts or $5 million.

This penalty will not be imposed unless the underpayment exceeds $5,000 ($10,000 for corporations other than S corporations or personal holding companies). (IRC 6662 (e)(2)).

Substantial Estate or Gift Tax Valuation Understatement

There is a substantial estate or gift tax valuation understatement if the value of any property claimed on an estate or gift tax return is 65% or less of the "correct" amount.

This penalty will not be imposed unless the underpayment exceeds $5,000.

Next ISSUE

Nexus will be summarized and up dated again in the next Taxletter.

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