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

Estate Tax – Close But No Cigar! Repeal Almost Happens

On June 8th the US Senate attempted to adopt "cloture" (cut off debate) to force a (likely favorable) vote to completely repeal US estate tax. (The US House of Representatives had already passed repeal legislation). The motion was narrowly defeated by 3 votes.

Then on July 30th the House instead voted a substantial permanent increase in the exemption and a dramatic slashing of the tax rates. But on August 3rd the Senate defeated the motion by 4 votes.

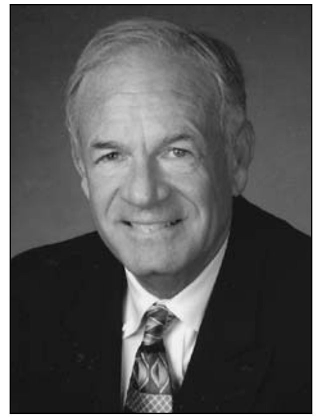
It is considered likely that estate tax legislation will be considered again after September 5th when the Congress returns from Summer recess. For updates please refer to our website www.taxintl.com.

Changes to the "Foreign Earned Income" Exclusion and "Housing Cost" Exclusion Create a Firestorm

US tax legislation enacted May 17th changed the rules on the "foreign earned income" exclusion and the "foreign housing cost" exclusion. The changes have unleashed a torrent of criticism. Please see the article "***CHANGES TO EXCLUSIONS FOR"FOREIGN EARNED INCOME" AND "FOREIGN HOUSING COSTS".***

More Meddling with Expatriation

The US senate recently passed a bill to further tighten the US "expatriation" rules for individuals, but the proposed legislation was not adopted by the House of Representatives. Thus the proposal was not enacted. The proposal would have implemented a form of deemed disposition on departure, with certain exemptions. Congress's continual interest in this topic suggests that more changes may be coming.



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.

Mergers of Non-US Corporations May Be Tax–Free

The IRS has determined that certain corporate mergers and consolidations undertaken by foreign corporations may qualify as tax-free reorganizations similar to the rules for domestic corporations. The change is effective for certain mergers and consolidations occurring after January 26, 2006. Please see the article ***"TAX-FREE MERGERS NOW POSSIBLE FOR NON-US CORPORATIONS"***.

New York Provides Relief to Nonresidents

We previously described circumstances where New York State considered nonresidents of New York to be subject to New York income tax if they were employed by an employer located in New York. However in a recently issued memorandum

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[TSB-M-06)(5)I] the NY Department of Finance has revised its position. The memo covers situations in which an employee whose assigned or primary work location is in New York performs services at that location and at a "home office" located outside New York. Any normal work day spent at the "home office" outside New York will be treated as a day worked outside NY (i.e. generally not taxed in NY) provided the "home office" is a "bona fide employer home office". The memo describes the factors to be considered to determine if the employee's "home office" is a "bona fide employer home office".

However please see the article ***"SOME NEXUS GUIDANCE - Income Tax on Telecommuters".***

No Canadian Adjustment Yet on Cross-Border Tax Credits for Joint Sale of US Realty

We previously mentioned the circumstances in which certain Canadian spouses resident in Canada that sell US real estate that is jointly owned (tenancy by-the entirety) may not be able to obtain a full deduction against their Canadian tax for US tax paid on the sale. This may occur when the Canadian residents are not US citizens or US residents and they have made disproportionate contributions to the purchase price of the US property.

In the US (for property held in most States) there will generally be an equal amount of federal income tax due on the profit by each spouse (assuming no other differentiating tax factors). However In Canada, the Canadian income tax on the profit is generally due proportionately by the spouses, based on the amount of the purchase price contributed by each spouse. But US tax paid by one spouse normally cannot be deducted on the Canadian income tax return of the other spouse unless a joint income tax return is filed by the spouses in the US - a filing status only permitted to US citizens and US residents. Thus the US tax paid by the lowest contributing spouse may not be fully creditable in Canada.

One possible alternative to ameliorate this result is to consider changing the ownership between spouses prior to the US sale.

Another possible alternative for certain snowbirds and others that meet the substantial presence test is to consider refraining from the filing of IRS Form 8840 (Closer Connection Statement). Instead a joint US income tax return can be filed reporting worldwide income. In this case Canada generally permits the US tax of one spouse to potentially offset the Canadian tax of the other spouse.

Louisiana Claims "Nexus" Because of In-State Contractor

A Louisiana court determined that an out-of state computer company that had no offices, stores, property, bank accounts, or employees in Louisiana, but had solicited orders within the State through national advertising, the use of mail order catalogues, and the Internet, and had contracted with a third party to provide on-site repair services for its products in Louisiana was deemed to have nexus in Louisiana for sales tax purposes. (Louisiana v. Dell International Inc., Louisiana Appellate Court, First Circuit, no. 2004 CA 1702)

New Jersey Supreme Court to Review "Nexus" Decision

In a further example of the ongoing confusion of the meaning of "nexus", the New Jersey Supreme Court has agreed to review a "nexus" decision we previously mentioned. A Delaware corporation that had no physical presence in New Jersey, but had licensed trademarks, etc., to a New Jersey clothing retailer, was deemed first by the Tax Court not to have a nexus in New Jersey, and later by the New Jersey Superior Court, Appellate Division, to have nexus in New Jersey. The New Jersey Supreme Court will now review the case.

New York Not Entitled to Income Tax on Retired Nonresident Partner's Share of NY Profits

An administrative law judge in New York has ruled that New York State is not entitled to personal income tax on the profits of a NY law Firm that are paid as retirement funds to a retired partner of the Firm living outside New York. The rule applies even when the payments are based on current profits of the Firm. (New York State Division of Tax Appeals, - Determination DTA No.820099 Feb 2, 2006).

Possible Federal Legislation Defining "Nexus" for States

The US Congress has been proceeding with proposed legislation that would expand the protection of P.L. 86-272 (the "Commerce Clause") beyond net income taxes on the sale of personal property to transactions involving services and intangibles and would define the "nexus" standard. (H.R. 1956 and S. 2721). But see the next section below.

State Tax Administrators Dislike Proposed Federal "Nexus" Legislation

At a meeting of the Federation of (State) Tax Administrators in June, the Executive Director stated that the proposed federal "nexus" law (mentioned above) is "bad legislation". Separately, similar comments were made by the Executive Director of the Multistate Tax Commission. It appears these organizations may work to defeat the proposed legislation.

Improved Deductions for Year 2005 Hurricane Losses

Special rules for Hurricanes Katrina, Rita and Wilma provide an opportunity for larger tax deductions than regular rules. Special tax credits are also available to certain business for wages paid while businesses were closed due to the hurricanes.

IRS "Timely Filing" Regulations Ruled Invalid

The US Tax Court has decided the "timely filing" tax return requirement for non-US corporations is invalid. Please see the article "***IRS "TIMELY FILING" REGULATIONS RULED INVALID".***

DETERMINING THE RESIDENCY (FOR US INCOME TAX) OF AN ESTATE

The determination of the residency of an estate for US income tax purposes is important because an estate that is resident in the US is potentially subject to US income tax on its worldwide income.

At one time the rules for determination of the residency of a trust and an estate were similar. However this changed when definitive rules for trusts (the US court test and control test) were implemented at the beginning of 1997. Since then, those "new rules" have applied to trusts but the "old rules" continue to apply to estates.

A review of these "new rules" for trusts is included here in the article ***"DETERMINING THE RESIDENCY (FOR US INCOME TAX) OF A TRUST".***

The "old rules" (which continue to apply to estates) consist of a series of precedents contained in various IRS Revenue Rulings, Private Letter Rulings, and court cases. Unlike the rules for trusts, there are no specific definitive tests to determine the residency of an estate.

One of the oldest such precedents involves a case in which the court was required to decide whether a trust was a "nonresident alien entity" for income tax purposes. (See Jones Trust v. Commissioner 46 B.T.A. 531 (1942)). The court concluded that in order to determine if a trust is a foreign trust the question is whether it is comparable to a nonresident alien individual.

Thus it is necessary to determine whether an estate is "alien" and whether it is a "nonresident". The estate must be both alien and nonresident to be a foreign estate. (i.e. as in these case of an individual, even if an estate is alien it might be a resident alien, in which case it is not a foreign estate).

In the Jones case the court decided the entity was alien, partly on the basis of the country under whose law the entity was created, and the status of the settlor, trustees, and beneficiaries.

With respect to residency, the court stated "*we think the residency of an entity should be determined by analogy to that of an individual*". At the time of that court case the residency of an individual was determined under different rules than today. At that time, an individual was a resident (for income tax) if the individual was "*actually present in the United States and not a mere transient or sojourner. Whether he is a transient is determined by his intentions with respect to the length and nature of his stay".* (Of course today we have the "substantial presence test" and the green card test to determine residency of an individual).

In the Jones case, the court determined that the trust's intention to retain its securities in the US without even a "floating intention" to remove them from the US was a significant factor in determining the residence of the trust. The court ultimately decided that "long, continued, and varied business activities in the US by the trust" denied the trust nonresident status, as did the presence of an "office".

Estates of Nonresident Alien Decedents

The IRS subsequently issued a series of Rulings, culminating in Revenue Ruling 62-154 addressing the residency of the estate of a nonresident alien individual.

In that Ruling the IRS concluded -

Whether the estate of a nonresident alien decedent, which is subject to domiciliary administration in a foreign country and ancillary administration in the US is a resident or nonresident alien entity for federal income tax purposes depends on all the facts involved, including the appointment of an ancillary administrator who is a citizen or resident of the US and the extent and duration of the activities of such ancillary administrator in the United States. Such an estate (as described above) is not automatically a nonresident alien estate. All factors must be considered, including whether the ancillary administrator is a US citizen or resident and the extent and duration of his/her activities in the US.

Estates of US Citizen Decedents

In Revenue Ruling 81-112 the IRS concluded that the estate of a US citizen who had been a resident of a foreign country for 20 years, whose spouse was a citizen of that country and was the primary beneficiary, whose administrators and executors were entities of that county, whose assets were all located in and administered in that country, and which estate was not subject to ancillary administration in the US, was a foreign estate.

The Ruling stated that the estate under review was alien because the assets were located in the foreign country and administered under the laws of that country, and the company and bank that held title to its assets were both incorporated and operating under the laws of that country. Only the residuary beneficiaries were not aliens - i.e. they were US citizens, but this was insufficient to weigh against the alien status of the estate.

The Ruling also stated that the estate under review was not resident in the US because it had none of the indicia of residency that were present in the Jones case above - i.e. the assets were not in the US and the management had no contact with the US.

General Conclusions

Although the rules are admittedly very vague, a review of the precedents suggests the following with regard to factors in evaluating whether or not an estate is "alien" and whether or not it is "resident" in the US:

1) The location of the estate's assets is very important,

2) The country of the estate's domiciliary administration is very important,

3) The nationality of and residency of the domiciliary personal representative is very important, and

4) The nationality of the decedent and beneficiaries is not very important.

Tax Treaty Override

As in the case of individuals, any given estate might be considered a resident of Canada under Canada's tax law and simultaneously a resident of the US under US tax law.

Article IV of the Canada/US tax treaty applies to estates as well as to individuals, and thus may override the US domestic law described above. Unfortunately however there are no "tie-breaker" rules as in the case of individuals. The treaty simply says *"where...........an estate.........is a resident of both Contracting States, the Competent Authorities of the States shall by mutual agreement endeavor to settle the question and to determine the mode of application of the Convention to such person".*

CHANGES TO EXCLUSIONS FOR "FOREIGN EARNED INCOME" AND "FOREIGN HOUSING COSTS"

On May 17th the US enacted new legislation making changes to the US income exclusions for "foreign earned income" and "foreign housing costs" affecting certain US citizens and US residents living and working outside the US.

The "good" news is that "inflation indexing" takes effect in 2006 and the maximum "foreign earned income" exclusion amount for 2006 is thus increased to $82,400. However there is other news also.

Foreign Earned Income Exclusion

Under the new rule, any foreign (non-US) earned income in excess of the exclusion amount will now be taxed at the same marginal tax rate as if the exclusion had not been claimed. Thus, for example, simplistically assuming there are no other tax factors to consider, an individual having $102,400 of taxable income and claiming the $82,400 exclusion will now be taxed on $20,000 at the tax rate applicable to the interval between $82,400 and $102,400. Previously the individual was taxed on the $20,000 at the rate applicable to the interval from zero to $20,000. The difference, for example, could be a 25% tax rate instead of a 10% tax rate on the $20,000, in addition to pushing other income into a potentially higher tax bracket.

Please refer to Exhibit 1 to evaluate your eligibility for the exclusion.

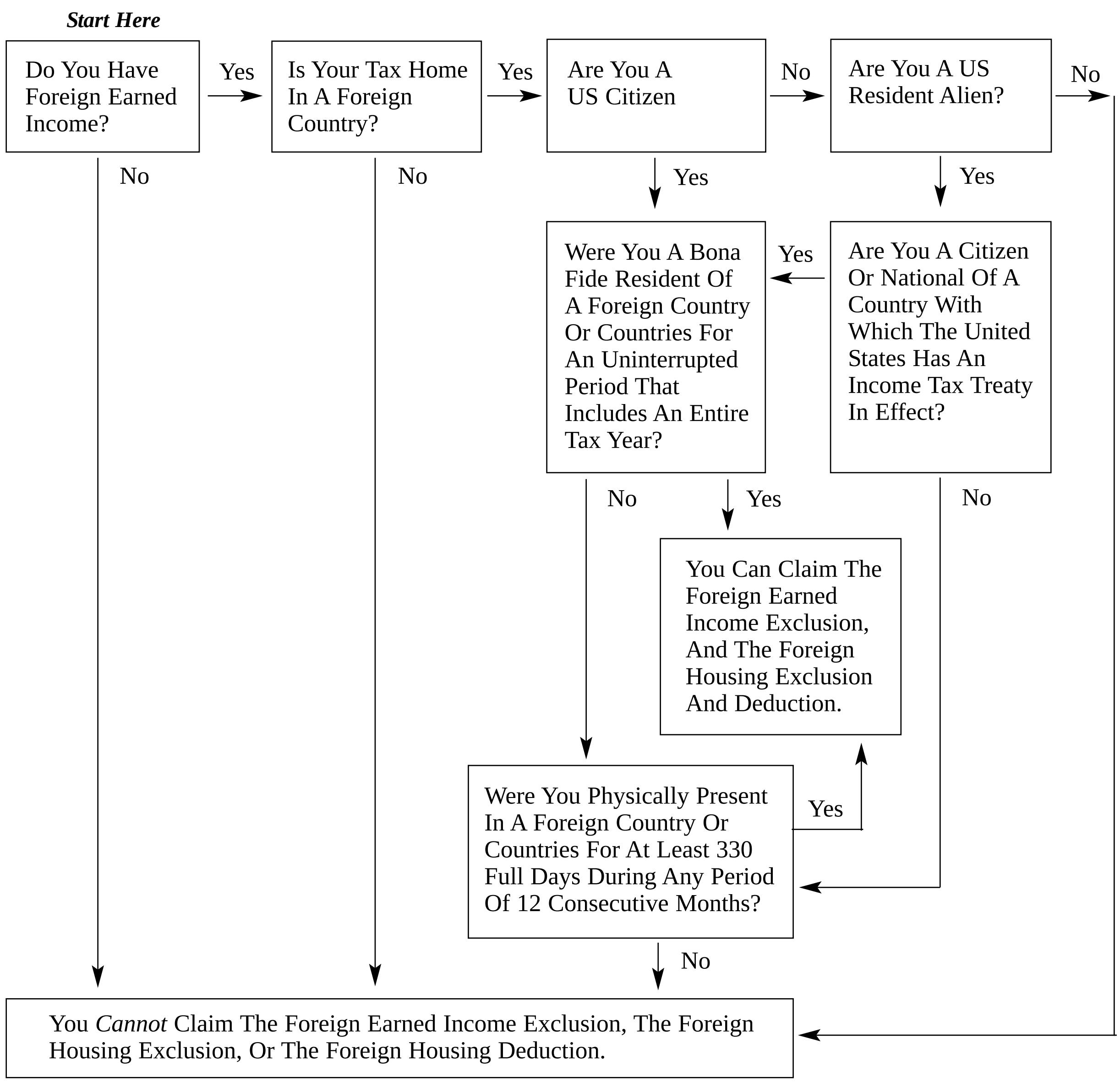
Housing Exclusion

Employees working abroad (outside the US) are also potentially entitled to exclude from income a portion of their housing expenses.

Your housing exclusion (the "housing cost amount") is the excess of your maximum "housing expenses" over the "base housing amount".

EXHIBIT 1

Can You Claim The Exclusion For Foreign Earned Income And/Or Foreign Housing Costs?



Source: IRS Pub. 54

The maximum amount for housing expenses is 30% of the foreign earned income exclusion. For 2006 the maximum therefore is $24,720.

The base housing amount is 16% of the foreign earned income exclusion. For 2006 the base housing amount is therefore $13,184.

Thus, for 2006 -

Housing Expenses (Maximum 24,720)
Minus
Base Housing Amount (13,184)
Equals
The Maximum Housing Exclusion
("Housing Cost Amount") - (11,536)

Therefore for 2006 the maximum exclusion for housing costs is only $11,536 ($24,720-13,184). For a description of allowable housing expenses please see the Winter-Spring, 2005, issue of the Taxletter.

Example: Max is a United States citizen living and working in downtown Toronto. His actual housing expenses, (rent, repairs, electricity, etc.) are $50,000 per year. However for the year 2006 his maximum potential exclusion for housing expenses (i.e. his "housing cost amount") is only $11,536 (24,720-13,184).

TAX-FREE MERGERS NOW POSSIBLE FOR NON-US CORPORATIONS

Canada and the United States each have their own separate set of tax rules governing corporate reorganizations, including circumstances in which the reorganization is "tax-free" for the parties involved. However since each country's set of rules is different, the tax results of any given corporate transaction may, of course, be different for Canadian taxpayers than US taxpayers. The discrepancy can be used to assist cross border tax planning, but it may also arise (perhaps inadvertently) to cause significant harm in other circumstances. This was especially evident for US citizens and US residents when BCE spun off shares of Nortel Networks in 2000.

These differences may affect a Canadian nonresident alien of the US and his/her private Canadian corporation. If, for example, the Canadian corporation conducts a US business, or owns US real estate, a Canadian change in the corporate structure may terminate the corporation for US purposes - thus triggering US tax on a deemed disposition at fair market value of the corporation's US real estate or other US assets.

Another example may affect a US citizen, green card holder (or other US resident) that lives in Canada and owns a private Canadian corporation. For Canadian tax planning purposes the individual's Canadian tax advisor may recommend some form of reorganization of the corporate structure. This may involve solely a change in the existing corporation or it may involve other new or existing corporations as well. Although the change may be structured to be "tax-free" in Canada, the reorganization may trigger a tax liability in the United States for the US citizen, green card holder (or other US resident) shareholder.

Mergers and Consolidations

One such typical "reorganization" is a "statutory merger" or "consolidation" – i.e. a transaction in which two or more corporations are combined in some way. A "merger" is a two-party transaction in which one corporation merges into a second corporation and the second corporation survives. A "consolidation" is generally a multi-party transaction that occurs when two (or more) corporations merge into a third corporation and the third corporation survives.

Until recently the United States generally considered a merger or consolidation under Canadian law to be a taxable transaction for US shareholders even if the transaction was tax-free in Canada. (See former Reg. 1.368-2T(b)(1)(i) that required a merger or consolidation to be effected pursuant to United States laws to be tax–free).

However, effective for transactions after January 26, 2006, new US tax regulations apply to foreign mergers and consolidations (but not all other types of foreign reorganizations). New Reg. 1.368-2(b)(1)(ii) generally provides that a tax–free merger or consolidation is a transaction effected by statute in which, by operation of the statute, the following events occur simultaneously at the effective time of the transaction:

1) All of the assets (other than those distributed in the transaction) and liabilities ………………of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or

more members of one other combining unit, and

2) The combining entity of each transferor unit ceases its separate legal existence for all purposes…………

Thus a merger or consolidation of Canadian corporations might be tax-free under US tax law if the transaction complies with the above requirements.

REMINDER ABOUT CERTAIN IRS REPORTING FORMS

Readers are aware of various IRS reporting forms that are required in a variety of circumstances and that have penalties up to $10,000 or even more, for each incidence of non-compliance. These forms usually must be filed by a deadline to avoid the penalty.

For example IRS Form 5471 is required when a "US person" (e.g. a US citizen, green card holder (or other US resident) or US entity), owns a specified amount of a non-US corporation, changes such ownership by a specified amount, or is a director or officer of a non-US corporation in which certain changes in share holdings are made by US individuals or entities. IRS Form 5472 is required when a non-US corporation is engaged in business in the US and has a "reportable transaction" or when a US corporation is more than 25% owned by non-US persons and has a "reportable transaction". IRS Form 8865 is required when a "US person" has a certain involvement with a non-US partnership.

A determination of when one or more of these forms is required is often difficult because of the rules for indirect and constructive ownership of corporations and partnerships. For example, shares of the corporation owned by another corporation might be deemed to be owned by the shareholders of the other corporation, and shares owned by one family member might be deemed to be owned by another family member.

Another IRS Form that carries a potential $10,000 penalty for noncompliance is IRS Form 8858. This Form is much less publicized - no doubt because the circumstances requiring it are far less common. IRS Form 8858 is required when a certain US individual or entity has a certain direct or indirect ownership interest in a "foreign disregarded entity".

Form 8858 may apply, for example, if a "US person" (see above) solely owns a non-US corporation for which a check-the-box election has been made to treat the corporation as a disregarded entity for US income tax purposes. Form 8858 may also apply, for example, if a "US person" (see above) solely owns a Nova Scotia or Alberta Unlimited Liability Company.

CARRYBACKS & CARRYFORWARDS OF TAX ATTRIBUTES

Readers are aware that tax losses and other tax attributes of a taxpayer that arise in one year may not always be fully "usable" in that tax year because of limitations applicable to that year. Thus an important factor in minimizing ongoing income tax is to ensure any applicable carrybacks and carryforwards are not overlooked and that prior tax returns are amended (where applicable) and future tax is appropriately reduced (where applicable).

Exhibit 2 provides a very simple abbreviated list of the US rules for carrybacks and carryforwards for Section 280A losses, passive activity losses, net operating losses, capital losses and foreign tax credits. Please consult your tax advisor before taking any action.

IRS "TIMELY FILING" REGULATIONS RULED INVALID

We previously described the IRS "timely filing" regulations. These regulations require nonresident aliens and non-US corporations that are required to file a US income tax return to actually file the return by a "deadline date". After the deadline date the individual or corporation is not allowed to deduct expenses. Thus the taxpayer is then subject to tax on gross receipts (sales receipts, gross rental receipts, etc,).

The "deadline date" for a tax return is 16 months after the "due date" for individuals and 18 months after the "due date" for corporations. The rationale for these regulations is the fact that, absent such a rule, there may be little incentive for the taxpayer to file a return until the IRS requests one (if ever). Thus the taxpayer would have an open-ended "option" to file a return at any date in the future.

However in a recent decision addressing corporations, the US Tax Court decided these regulations are invalid on the basis the tax code itself does not contain such a deadline. Nonetheless, this may not be "the end of the story".

First of all, there was dissent among the Tax Court judges with respect to the opinion, and the IRS is likely to appeal the decision. If the IRS does not achieve success in the Appeals Court it may seek to have Congress enact new legislation actually imposing a "deadline date" in accordance with the disputed regulation.

In addition, there is <u>court precedent</u> for a "terminal date" after which a taxpayer <u>can not deduct expenses</u>. Such a "terminal date" has been determined to be when the IRS has prepared a substitute return and determined tax deficiencies against the taxpayer. (Taylor Sec. v. Commissioner 40 B.T.A. 696 and Blenheim Co. v. Commissioner 42 B.T.A. 1248).

Further, the tax code itself contains a "terminal date". Section 6020(b)(1) states *"If any*

<u>EXHIBIT 2</u>

Carryforwards And Carrybacks: US Rules For Tax Attributes (1)

	Individuals		Corporations	
	Rules	Tax Code Section		Tax Code Section
(2) Section 280A Losses	No Carryback Carried Forward Indefinitely	280A 280A(c)(5)	Not Applicable Except To S Corporations (See "Individuals")	280A
(3) Passive Activity Losses (PALs)	No Carryback (4) Carried Forward Indefinitely	469 469(b)	Applicable Only To "Closely Held" C Corporations And Personal Service Corporations (See "Individuals")	469(a)(2)
Net Operating Losses (NOLs)	Carried Back 2 Years (5) (6) Carried Forward 20 Years	172(b)	Carried Back 2 Years (5) (6) Carried Forward 20 Years	172(b)
Capital Losses	No Carryback Carried Ahead Indefinitely	1212(b)	Carried Back 3 Years (7) Carried Ahead 5 Years	1212(a)
Foreign Tax Credits	Carried Back 1 Year And Then Ahead 10 Years (8) (9)	904(c)	Domestic Corporations - Carried Back 1 Year And Then Ahead 10 Years (8) (9)	904(c)

(1) Many Special Rules And Exceptions Apply. Please Contact Your Tax Advisor Before Taking Any Action.

(2) Applicable To Certain Rental Properties Where There Is Personal Use Of The Property.

(3) Applicable To Certain Business Activities In Which The Taxpayer Does Not "Materially Participate" Including Most (But Not All) Rental Activities.

(4) Note However That A PAL Can Be Transformed Into An NOL (For Example On Disposition Of The Activity).

(5) Some Exceptions Apply - See Code Section 172.

(6) Net Operating Losses <u>Must</u> Be Carried Back First, Unless You Specifically Elect To Only Carry Forward. (IRC 172(b)(3)).

(7) Corporate Capital Losses <u>Must</u> Be Carried Back First. There Is No Provision To Elect To Only Carry Forward. (Reg. 1.1212-1(a)(3)(ii)).

(8) Tax Credits <u>Must</u> Be Carried Back First - There Is No Provision To Elect To Only Carry Forward. (IRC 904(c)).

(9) Any Tax Carried Over To Years Ending After October 22, 2004 Is Entitled To A Total 10 Year Carryover Period. (Reg. 1.904-2T(a)).

person fails to make any return .... at the time prescribed therefore, ... the Secretary shall make such return *from his own knowledge* (emphasis added) *and from such information as he can obtain through testimony or otherwise*. Section 6020(b)(2) goes on to state *"any return so made ...... shall be prima facie good and sufficient for all legal purposes".*

For those foreign corporations and non-resident aliens that are genuinely unsure whether a US income tax return is required, consideration can be given to filing the "protective" tax return we previously described. This will likely commence the statute of limitations, while simultaneously protecting your right to claim deductions for the intervening "open" years if the IRS questions your position in the future before the statute expires.

As a separate issue, we have not seen any evidence of the IRS applying the timely-filing rule in connection with residency claims under the tax treaty. However it appears such a rule could be possible, since the IRS may consider the rationale for such a deadline to be similar to the rationale for the expense deductions described above. (i.e. without such a deadline a dual resident has an open-ended option to file a tax return claiming nonresident status at any time in the future).

DETERMINING THE RESIDENCY (FOR US INCOME TAX) OF A TRUST

In a prior Taxletter we summarized the rules for determining the residency (for US income tax purposes) of a trust. A trust is taxed as a US trust (a "domestic trust") if it meets the "US court test" and the "control test". The present rules are found in Code Section 7701(a)(3)(E). Naturally the determination of the residence of a trust is important because it affects whether the trust is taxed in the US, and whether it is taxed in the US on its worldwide income.

US Court Test

A trust is a domestic trust only if a US court exercises primary supervision over the administration of the trust. What does that mean? Apparently in many cases it may not be clear what it means, but you can insert language in the trust instrument to make it clear.

Under Reg. 301.7701(a)(c)-7(3)(iv) the term "administration of the trust" means the carrying out of the duties imposed on a fiduciary by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, defending the trust from lawsuits by creditors, and determining the amount and timing of distributions.

Regs. 301.7701-7(c)(3)(ii) and (iv) state that a US court is able to exercise "primary jurisdiction" over a trust if the court could have the authority under applicable law, to render orders or judgments resolving issues concerning substantially all issues regarding administration of the trust. According to Reg. 301.7701-(c)(3)(iv), simply having jurisdiction over the trustee, a beneficiary, or trust property is not equal to having "primary supervision over the administration of the trust".

The Regulations provide the following examples:

Example 1: B, a US citizen, executes a trust instrument for the equal benefit of B's two US children. The trust instrument provides that DC, a US corporation is to act as trustee and that the law of State Y, a state within the US, is to govern the trust, but that the trust is to be administered in Country X . (emphasis supplied). Under the law of Country X, a Court within Country X is able to exercise primary supervision over the administration of the trust but, as required by the trust instrument, applies the law of US state Y to the trust. Thus the trust fails the US court test and therefore is not a US (domestic) trust.

Example 2: Trust T owns a single asset, an interest in land located in State Y, a state within the US. Under the law of State Y, a trust owning solely real property within the state is subject to the primary supervision over the administration of the trust by a court within State Y. Therefore the trust satisfies the US court test. (Regs. 301.7701-7(a)(1)(i) and (c)(10).

Since the law and regulations focus on the administrative power of the courts and not on the governing law stipulated by the trust instrument, it could be important for the trust document to specifically stipulate the jurisdiction where the trust will be administered, in addition to the jurisdiction whose laws will be applied. In this manner you can help control whether the trust will be a domestic or foreign trust.

The regulations also contain four "bright-line" examples for meeting the "US court test" if you wish to do so:

1) The fiduciary appropriately registers the trust in a US court in accordance with Reg. 301.7701-7(c)(4)(i)(A),

2) A testamentary trust is established under a decedent's Will probated within the US (and other requirements are met),

3) A US court is petitioned to cause its administration to be subject to the primary supervision of the US court, or

4) There is co-supervision over the administration by the US court and a court of a foreign jurisdiction. (Reg. 301.77017(c)(4)(i)(D)).

For more information please refer to Reg. 301.7701-7(c)(4).

The Control Test

A trust is a domestic trust only if one or more US persons has the authority to control, by vote or otherwise, all substantial decisions of the trust. (A "US person" is a US citizen or resident, a US partnership, a US corporation, and a US (domestic) estate or trust). Thus the "control" need not be held by a fiduciary - it can be held by a trust "protector", or investment manager, for example.

Therefore the trust instrument should include language addressing the issue of control over "substantial" decisions of the trust, in order to accomplish your objective with respect to whether you wish to have a US (domestic) or foreign trust.

Tax Treaty Override

As in the case of an estate, (see ***"DETERMINING THE RESIDENCY (FOR US INCOME TAX) OF AN ESTATE"*** above) any given trust might be considered a resident of Canada under Canada's tax law and simultaneously a resident of the US under US tax law.

Article IV of the Canada/US tax treaty applies to trusts as well as to individuals, and thus may override the US domestic law described above. Unfortunately however there are no "tie-breaker" rules for trusts as in the case of individuals. The treaty simply says *"where ……… a trust …. is a resident of both Contracting States, the Competent Authorities of the States shall by mutual agreement endeavor to settle the question and to determine the mode of application of the Convention to such person"*.

CORPORATE EXPATRIATIONS (AND ESTATE TAX)

Special rules may apply for 10 years when certain US corporations "reincorporate" in a foreign jurisdiction. Some of these transactions are referred to as "inversion transactions". When the rules apply, it is possible the foreign corporation will be taxed in the US as if it is a US corporation.

For example, if there is a transaction in which:

A US corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity, and

The former shareholders of the US corporation hold (by reason of holding stock in the US corporation) 80 percent or more (by value) of the stock of the foreign-incorporated entity after the transaction, and

The foreign-incorporated entity, considered together with all companies "connected" with it does not have substantial business activities in the entity's country of incorporation, compared with the total worldwide business activities of the expanded affiliated group,

then -

the top-tier foreign corporation might be treated as a domestic (US) corporation for ***all*** US tax purposes. (IRC 7874).

A separate rule applies if the stock holding meets only a 60% test rather than the 80% test.

Because the rules treat the foreign corporation as a US corporation for ***all US tax*** purposes, the shares in the foreign corporation will be considered "US property" and thus potentially subject to US estate tax! This may inadvertently escape the attention of individuals owning such shares.

Thus, for example, if a Canadian owns a private US corporation and transfers the shares to a Canadian corporation (intending, for example, to avoid US estate tax) the Canadian corporation could possibly become a US corporation for US income and estate tax purposes. (See Reg. 1.7874-2T(b)(1)).

Beware Certain US Corporate Liquidations!

Under a completely separate rule, danger may arise on the liquidation of a US holding company into a foreign parent corporation. Normally, if a US corporation has sold all its assets and paid the relevant US tax, the corporation can then be liquidated and its cash distributed to a foreign owner (nonresident alien or foreign corporation) without any further US tax being due. However, if the US corporation is an "applicable holding company" and there are retained earnings in the corporation, the liquidation could instead be treated as a dividend subject to US tax. (See IRC 332(d)).

An "applicable holding company" means any US corporation that:

1) Is a common parent of an "affiliated group",

2) The stock of which is directly owned by the distributee foreign corporation,

3) Substantially all of the assets of which consist of stock in other members of such affiliated group, and

4) Which has not been in existence at all times during the 5 years immediately preceding the date of liquidation.

US ESTATE TAX LIENS, LIABILITIES, ETC.

There are many confusing tentacles associated with the impact of US tax liabilities on the sale of US real estate after the death of a nonresident alien joint owner.

Occasionally real estate closing agents in the US have apparently inadvertently applied US domestic tax law rather than cross-border tax law to such real estate sale transactions, thus overlooking the estate tax liabilities.

When an individual dies owning US real estate that passes to a surviving spouse that is a US citizen there is generally no US estate tax applicable on the real estate at that time. That results from the fact there is an unlimited marital exemption on present interests of assets passing to a US citizen spouse. However there is no such unlimited marital exemption when the property passes to a surviving spouse that is not a US citizen. Generally a US estate tax return must be filed and US estate tax may be payable.

Naturally, US closing agents most commonly work on real estate transactions where the surviving spouse is a US citizen. Hence it may be understandable for closing agents to occasionally overlook the aforementioned estate tax rules when the surviving spouse is not a US citizen. In such a case the sale of the real estate often proceeds and the Canadian (or other foreign) seller immediately receives the proceeds of the sale even though US estate tax matters have been inadvertently disregarded. In this case all of the following may have a potential liability for any US estate tax that may be payable:

1) The closing agent,

2) The surviving spouse (or other heirs),

3) The Executors, and

4) Canadian and US accountants and lawyers having "control" over proceeds.

Correct Procedure to Follow

When a nonresident aliens dies while owning US property (real estate, stocks, etc) valued in excess of $60,000, a US estate tax return must be filed. The gross value of jointly owned property is used for this determination.

If US real estate, jointly owned with a surviving spouse, is to be sold, there is generally no US court probate required and therefore there is no executor/personal representative appointed by a court in the United States. In this scenario the US tax law designates the closing agent for the real estate sale to be a "statutory executor". Similarly, a Canadian lawyer, accountant, executor or other Canadian "in control of assets" owned by the decedent is simultaneously considered to be a "statutory executor".

Under US federal rules, a "statutory executor" has full liability for the US estate tax, to the extent of assets under his/her control. In order to free himself/herself from this federal tax liability and receive authorization to distribute proceeds of the sale to the seller, the "statutory executor" must:

1) Receive a copy of the IRS Estate Closing Document showing all estate tax paid, or (since it will normally take 12-18 months for the IRS to issue the Estate Closing Document),

2) Obtain an IRS "transfer certificate", that can be obtained in about 4 weeks. The transfer certificate will only authorize a portion of the sales proceeds to be dispersed to the seller. The balance must remain in escrow until the IRS Estate Closing Document is received.

Result of Incorrect Procedure

Apart from the contingent liabilities for statutory executors described above, various other liabilities arise, even if an executor/personal representative is appointed in the United States.

Under Code Section 6324(a)(1) an IRS tax lien is imposed on the gross estate of the decedent for 10 years. Further, under Code Section 6324(a)(2) any joint owner, beneficiary, or person in possession of property via a "power of appointment" is personally liable for unpaid tax, up to the amount under his/her control.

If the joint owner, beneficiary, or person in possession of property via a "power of appointment" transfers/sells the property to a bona fide, arms length purchaser, or holder of a "security interest", the IRS lien referred to above is removed from the property but is transferred to all the property of the joint owner, beneficiary, trustee, or person in possession of property via a "power of appointment".

What is the status of the buyer of the real estate if tax is due but not paid?

Under Code Section 6324(a)(2) and Revenue Ruling 56-144 a purchaser that deals at arms' length with the transferor and pays a full and adequate consideration for the property will acquire good title to the property, overriding the IRS 10 year lien.

Otherwise, in jurisdictions where title insurance is provided, the buyer can make a claim against the insurance policy for the tax due. The insurance company would then likely attempt to recover the tax, interest, and penalties from the heirs, executors/personal representatives, and accountants and lawyers that are "statutory executors".

VALIDITY OF A LIMITED PARTNERSHIP WITH A CORPORATE SOLE GENERAL PARTNER

Limited partnerships may occasionally be preferable over general partnerships for investment or business activities, due to the limited nature of the liability of the limited partners. General partnerships, where each partner has personal liability, can be formed solely by intent of the partners. A limited partnership, where the liability of the limited partners is limited, can only be formed under an individual State statute (The Revised Uniform Limited Liability Partnership Act).

A limited partnership (by definition) requires that at least one general partner with unlimited liability exist. Therefore, many limited partnerships are formed with a corporation as the sole general partner, thus indirectly limiting the liability of the partners (beyond the assets of the partnership) to the assets of the corporate general partner itself.

Before the advent of the "check-the-box-rules, (Please see the article "***CAVEAT FOR CANADIAN PARTNERSHIPS INVESTING IN US REAL ESTATE***") the IRS could potentially deem a partnership to be taxed instead as a corporation, if the corporate general partner was "insubstantial" - e.g. did not have sufficient net worth, thus meaning that significant exposure to liability was not present.

Since 1997, in the case of non-publicly traded entities, apparently the "check-the-box" rule generally permits limited partnerships to elect to be treated as a partnerships without regard to whether there is an "insubstantial" general partner.

US CITIZENS AND GREEN CARD HOLDERS WITH PRIVATE CANADIAN CORPORATIONS - BEWARE "CFC" RULES

Although we now have "good news" for US citizens and residents with respect to the Canadian merger of Canadian corporations (Please see the article "***TAX-FREE MERGERS NOW POSSIBLE FOR NON-US CORPORATIONS***") other circumstances with Canadian corporations can still trigger unpleasant US tax consequences. Some of these are applicable to the ownership of "controlled foreign corporations" (CFC's).

A CFC is a non-US corporation where more than 50 per cent of the voting power or value is owned (or considered owned) by "United States Shareholders" on any day during the year. (IRC 957)).

A "United States Shareholder" means a US "person" (a US individual, corporation, partnership, trust or estate) that owns (or is considered to own) 10 percent or more of the voting power.

Thus - you add up the voting power and stock value of each US individual, US corporation, etc., that owns 10% or more of the

EXHIBIT 3
Section 951 Income*

US Citizens And US Resident Individuals (Including Certain Green Card Holders Living Outside The US) That Are US Shareholders Of "Controlled Foreign Corporations" Must Include On Their US Income Tax Return Certain Corporate Amounts, As Follows, Even When The Amounts Are Not Paid To Them.

The Amount The Investment Exceeds The Lesser Of The Shareholder's Share Of:
1) "Untaxed" Accumulated Earnings And Profits
Or
2) "Applicable Earnings" (IRC 956(a))
Note 5

Investment In Certain "US Property" (IRC 951(A)(1)(B)) **Note 4**

Current Year "Subpart F Income" (IRC 951(a)(1)(A)

Previously Excluded Subpart F Income Withdrawn From Certain Investments By Certain Shipping Operations (IRC 951(a)(1)(A)

Certain Insurance Income

"Foreign Base Company Income" (IRC 954)

Certain International Boycott Income

Certain Bribes Kickbacks, Etc. Made

Income From Certain "Blacklisted" Countries

De Minimus Exception **(Note 1)**
Special Rule **(Note 2)**
High Tax Exception **(Note 3)**

Foreign Personal Holding Company Income (IRC 954(c))

Foreign Base Company Shipping Income (IRC 954(f))

Foreign Base Company Services Income (IRC 954(e))

Foreign Base Company Oil Related Income (IRC 954(g))

Foreign Base Company Sales Income (IRC 954(d))

Dividends, Interest, Rents, Royalties, Annuities, Certain Capital Gains (IRC 954(c)(1) Certain Commodity Transactions And Certain Currency Gains (IRC 954(c)(1)(D).

<u>Excluded</u> Are: Rents And Royalties Received In An Active Business From An Unrelated Party (IRC 954(c)(2) <u>And</u> Rents And Royalties Received From A Related Corporation Using The Property In The Same Country (IRC 954(c)(3)(A)(ii). Other Exceptions At IRC 954 (b)(5) and IRC 954 (c)(6).

Technical, Managerial, Engineering, Architectural Scientific, Skilled, Industrial, Commercial, Or Like Services Performed For, Or On Behalf Of, A Related Person, Performed Outside The Country Of Corporate Organization. Exceptions At IRC 954(e)(2) And 954(b)(5)).

Income Derived In Connection With The Purchase Of Personal Property From A Related Person And Its Sale To Any Person, The Sale Of Personal Property To Any Person On Behalf Of A Related Person, The Purchase Of Property From Any Person And Its Sale To A Related Person, Where The Property Is "Produced" Outside The Country Of Corporate Organization And The Property Is Sold For Use Outside Such Country. Exceptions At IRC 954(b)(5).

<u>NOTE 1</u> Generally, No Part Of The Taxable Income For The Year Will Be Treated As Foreign Base Company Income (FBCI) Or Insurance Income If The Sum Of FBCI And Insurance Income Is Less Than The Lesser Of: 5% Of Gross Income, Or $1,000,000 (IRC 954(b)(3)(A)).

<u>NOTE 2</u> If The Sum Of Foreign Base Company Income (FBCI) And Insurance Income Exceeds 70% Of Gross Income The Entire Gross Income Will Be Treated As FBCI Or Insurance Income (Certain Deductions Allowed). (IRC 954(b)(3)(B))

<u>NOTE 3</u> FBCI And Insurance Income Shall Not Include Any Income Subject To An Effective Foreign Country Tax Rate Greater Than 90% Of The Maximum Tax Rate In Code Section 11. (IRC 954(b)(4)).

<u>NOTE 4</u> Except For The "Exceptions" below, "US Property" In This Case (See IRC 956(c)(1) Is: 1) Tangible Property In The US, 2) Stock Of A Domestic Corporation, 3) Debt Of A US Person, 4) Any Right To Use In The US Of A Patent, Copyright, Etc. Exceptions: 1) Obligations Of The US, Money, Or Deposits With Certain Banks, 2) Certain "Export" Property, 3) Certain "Accounts Receivable", (IRC 956(c)(2)(C), But See IRC 956(c)(3), 4) Certain Shares And Debt Of Domestic Corporations And Obligations Of Non-Corporate US Persons Where There Is Limited Common Or Inter-Related Ownership. (IRC 956(c)(2)(F), And (c)(2)(M), 5) Other Exceptions Apply, See IRC 956(c)(2).

<u>NOTE 5</u> "Applicable Earnings" Means The Sum Of: 1) Current Earnings And Profits, And 2) Accumulated Earnings And Profits Reduced By Distributions During The Current Year And Certain Earnings And Profits Previously Included In Income. (IRC 956(b)(1)).

<u>*NOTE: Many Exceptions Apply - Please Contact Your Tax Advisor For Details</u>

voting power. If either total (voting or value) exceeds 50%, the corporation is a CFC.

Beware – there are complex rules to determine how much stock you are considered to own. For example, you are considered to own any stock actually owned by your spouse, child, or parent, (unless he/she is a nonresident alien) and stock held by certain corporations, trusts ,and estates in which you have an interest.

If you are a "US Shareholder" in a CFC the most common tax implications for you may be the rules for:

1) "Investment in US Property", and
2) "Subpart F - Foreign Base Company - Foreign Personal Holding Company Income".

Please see Exhibit 3 for a summary of those and other rules that may apply.

Investment in US Property

In addition to its impact on US citizens and green card holders living in Canada, this provision commonly affects Canadians that move to the US while retaining a private Canadian corporation back in Canada.

Under this set of rules, if your private Canadian corporation is a CFC and has accumulated earnings that have not been paid to you, you will trigger potential US tax on the those earnings for yourself, if you are a "US Shareholder" and you invest the corporation's cash in certain "prohibited" assets. This occurs for example if you loan funds from the Canadian corporation to you personally, or to your US corporation, or if the corporation purchases US real estate. (See Exhibit 3).

Subpart F - Foreign Base Company - Foreign Personal Holding Company Income

Other provisions that may affect you are the "Subpart F" rules and especially the category thereof referred to as "foreign base company income". Within that subset of rules the ones most likely to affect you are the rules for "foreign personal holding company income". (See Exhibit 3).

Under the general rule for "foreign personal holding company income", if you are a "US Shareholder" in a CFC you will be taxed personally on your US income tax return for the following income earned by the corporation, even if it is not paid to you:

1) Dividends,
2) Interest,
3) Rents, and
4) Certain capital gains.

Exceptions generally apply if:

1) The above income is less than a de minimus amount - e.g. the sum of foreign personal holding company income plus all other "foreign base company income" and "insurance income" (see Exhibit 3) is less than the lesser of:
   a) 5% of gross income, or
   b) $1million (IRC 954(b)(3)),
2) The high tax exception applies – e.g. the foreign base company income and insurance income is subject to an effective foreign tax rate greater than 90% of the US corporate tax rate, (IRC 954(b)(4)),
3) The rental income is received in an active business from an unrelated party, (954(c)(2)(A)) or
4) The rent is received from a related corporation using the property in the same country. (IRC 954(c)(3)(A)(ii)).

(For more detail see Exhibit 3 and Code Section 954).

SOME "NEXUS" GUIDANCE

Readers are aware that individual States levy income tax, sales tax, and/or franchise tax on corporate business activity, generally depending on whether the corporation has "nexus" within the State. Unfortunately each State defines "nexus" differently. Further, within each State a different standard is often used to define "nexus for income tax", vs. "nexus for sales tax", etc.

A recent survey provides some guidance on when individual States (on average) consider "nexus" to exist in each category. A few examples follow.

Sales Tax on Personal Property

In general, with exceptions, most States will consider an out-of–State corporation that makes sales of personal property within the State solely by internet, telephone or catalog/direct mail (collectively referred to as "remote sales") as being liable for sales tax in that State only if:

1) The business sends an employee into the State four or more times during the year,
2) The business sends an employee or independent contractor into the State to install or repair property,

3) The business delivers merchandise into the State in company-owned vehicles, or

4) There is participation in a trade show in the State (results may differ depending upon whether orders are accepted at the show).

Income Tax on Consulting Services

Of course, performing significant consulting services within a State will, in general, create "nexus" in that State. Alarmingly, a handful of States will assert "nexus" even if there are 6 or fewer days of consulting within the State.

Income Tax on Telecommuters

An apparently dangerous new area of tax exposure for individuals is the State income tax liability for individuals involved in telecommuting.

For example an individual living and working in State "A" may be subject to personal income tax in State "B" if he/she telecommutes with an employer based in State "B". Not all States agree. See also "***New York Provides Relief to Nonresidents"*** above, under ***"LEGISLATIVE/ADMINISTRATIVE/ JUDICAL UPDATE".***

Registering in the State

In a few States the simple act of registering to do business or holding a certificate of authority in the State will trigger nexus for income tax, even if the entity has no intention of actually conducting business in that State. Among other circumstances, this can make it awkward for a Canadian corporation that wishes to open a US bank account, since many banks require such corporations to register to do business before they will open the account!

CAVEAT FOR CANADIAN PARTNERSHIPS INVESTING IN US REAL ESTATE

The use of a partnership by Canadians for a US real estate investment or to conduct US business can be helpful in many situations. This structure may result in reduced worldwide tax, especially if it results in one level of tax worldwide along with a direct offset of US tax against any Canadian tax.

For example, if two Canadian individuals form a partnership (respected as such in both Canada and the US) to invest in US real estate or a US business, the partnership would normally not pay any federal income tax in either country. Instead each partner would file personal income tax returns in each county. Any personal tax paid by each partner in the US on the partnership's US income, would potentially reduce all or part of each partner's Canadian income tax on the partnership's US income. Thus the worldwide income tax could potentially be limited to the greater of the Canadian or US marginal tax rates. (US estate tax matters are a separate concern).

However a danger may arise if the partnership is a Canadian partnership and its partners are comprised solely of Canadian corporations. This risk stems from the "default" rules under the US "check-the-box" regime.

Under the "check-the-box" rules certain entities (referred to as "eligible entities") can elect to be taxed in the US either as a partnership or corporation. The election is determinative, as along as it is a valid election. But if you do not make the election certain "default" rules may apply.

Default Rules for Canadian and Other Foreign Entities

If your entity is a Canadian eligible entity (for example a routine Canadian partnership) and you do not make the check-the-box election in the US, the partnership will normally be taxed as a corporation in the US if all the partners are routine corporations (i.e. provide limited liability). Obviously this could present a potentially harmful surprise if it is not anticipated in advance. The Canadian partnership could be subject to US federal (and perhaps State) corporate income tax. There might even be a US corporate branch tax, or a US dividend withholding tax on distributions from the entity.

There could be a further danger if the Canadian corporate partners assume they have a partnership for US tax purposes and cause their Canadian corporations to file US income tax returns as partners and pay US tax. If the IRS later determines the Canadian partnership is to be taxed in the US as a corporation and demands US corporate income tax from the Canadian partnership, it may be too late for the Canadian corporate partners to claim a US tax refund for the tax they paid previously. The refund deadline rules are complex but can be as little as 2-3 years after payment of the initial tax.

Thus, if you have such a partnership in which all partners are corporations and you wish to be taxed in the US as a partnership, you may wish to make the election to be treated as such.

Additional default rules apply. For example special rules apply to entities "whose classification was relevant" for US purposes prior to the introduction of the check-the-box rules. Please consult your tax advisor before taking any action.

Default Rules for Domestic Entities

Unlike the rules for Canadian and other foreign entities, if an entity is a domestic (US) eligible entity and it does not make an election, it will be taxed in the US as partnership if it has two or more partners.

Additional default rules apply. Please consult your tax advisor before taking any action.

INADVERTENT US TAX ON CANADIAN BUSINESSES HAVING US RELATED PARTIES

What are the circumstances under which a Canadian business, operating only in Canada, will (unexpectedly) be subject to US tax? For example, what is the US income tax status of such a Canadian business whose Canadian owner supervises it four months annually via email and teleconferencing from his winter home in the United States?

In order to be subject to US income tax on its business income a Canadian corporation must, among other factors, be "engaged in a trade or business" in the US. There is no overall precise definition of "engaged in a trade or business" in the US. Apart from the performance of personal services in the US it may include any activity that is conducted "regularly" and "continuously" and is capable of generating income. This activity may be conducted by an employee or certain agents that are not "independent". Hence regular managerial and other activities by the aforementioned Canadian business owner while in the US could, perhaps, cause his Canadian corporation to be engaged in business in the US.

However, in the case of a Canadian business, readers are aware the business is still not subject to US tax on its business income unless it has a "permanent establishment" in the US. If the owner conducts his activities solely from his residence while in the US, does the Canadian business have a permanent establishment in the US? Apart from the obvious, such as an office, a "permanent establishment" may exist if there is an agent in the US that has the authority to conclude contracts and regularly exercises it. Of course this fact pattern could apply in our "owner scenario" thus giving the Canadian business a US "permanent establishment" ("PE").

Nonetheless, all is not yet lost for the Canadian business, insofar as its US tax status is concerned. The business is still only subject to US tax on its income that is "effectively connected" with its US business. Since the business operates only in Canada, and only with Canadian customers, is any of its income "effectively connected" with its US business?

The corporation will have "effectively connected" income if it has income "attributable" to the US "PE". Profits attributable to the PE must result from the assets or activities of the PE. Apart from other factors it is necessary to determine if the US activities were a "material factor" in the generation of the Canadian corporations' income. Whether the owner's activities were a "material factor" could be important.

Thus it can be seen that, in some cases, the activities of a "related party" in the US may potentially subject a Canadian business to US federal tax. (Since the individual State threshold for "nexus" is often lower than the federal threshold for PE, State income tax may apply as well, or even before, the application of federal tax).

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