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

4710 NW 2ND AVENUE, #101, BOCA RATON FL 33431 / TEL 561-241-9991 / FAX 561-241-6332 / RB@TAXINTL.COM / WWW.TAXINTL.COM

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LEGISLATIVE, ADMINISTRATIVE AND JUDICIAL UPDATE

South Carolina Fires Another "Nexus" Salvo

The South Carolina Department of Revenue has determined that an out-of-state retailer that ships property into South Carolina via a common carrier (e.g. UPS) will be subject to the county's sales tax (under the due process clause of the US Constitution) if the retailer advertises via advertising media located outside the county of delivery, if there is coverage within that county. The Department claims this, even if there is no physical presence within the county. (Revenue Ruling 06-16, South Carolina Department of Revenue).

US Federal Inflation Adjustments for 2006

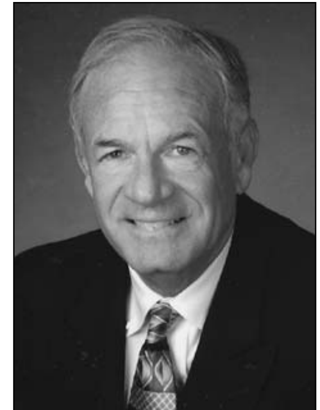
The IRS issued a complete summary of inflation adjustments for 2006 in Revenue Procedure 2005-70. Among them, the annual exclusion for gifts becomes $12,000 (for gifts to nonresident alien spouses it becomes $120,000).

Under the "expatriation" rules of Code Section 877, the average annual net income tax threshold becomes $131,000.

IRS Consolidates Some Extension Application Forms

For tax years that end on, or after, December 31, 2005, you must now use a different IRS Form to request an extension of time to file certain tax returns. Please see the article ***"IRS FORMS FOR EXTENSION APPLICATIONS".***

IRS Issues New Rules for US Withholding Tax on US Wages Earned by Nonresident Aliens



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.

IRS Notice 2005-76 provides amended rules for employers to compute the US wage withholding by US employers on nonresident aliens that earn US wages. The change is intended to reduce or correct overwithholding. Also, in Notice 2005-77 the IRS stated it intends to amend the regulations to create a new exemption to the filing requirement for nonresident aliens who are required to file a return solely because of wages that do not exceed the personal exemption amount.

US Immigration Department And IRS to Exchange information?

The US Government Accountability Office (GAO) has issued a report on a study of the potential sharing of information between the US Citizenship and Immigration Services, (USCIS) and the Internal Revenue Service (IRS).

The study determined that IRS compliance efforts could benefit from such data sharing, especially if businesses applying for immigration sponsorship programs were required to show they had complied with US tax law.

Similarly the study determined that the USCIS could benefit from such data sharing

*ADDRESSES ONLY U.S. FEDERAL ISSUES -- STATE AND LOCAL ISSUES MAY ALSO APPLY.
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TEL (561) 241-9991 • FAX (561) 241-6332 • E-MAIL RB@TAXINTL.COM • WWW.TAXINTL.COM
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regarding the eligibility of businesses applying to sponsor workers.

Internal Revenue Code Section 6103 would have to be amended to permit the IRS to directly disclose taxpayer information to the USCIS.

IRS to Audit Payments to Foreign Investors

The IRS has announced it will begin to audit financial institutions that are required to withhold taxes on payments to foreign taxpayers. The audit will focus on dividends, interest, and royalties. The IRS issued a reminder that payers must report the payments, even if no withholding is required.

INCREASED INTEREST IN TRUSTS FOR US ESTATE TAX

Readers are aware the Canada Revenue Agency (CRA) eliminated certain Canadian income tax benefits for new "single purpose corporations" that purchase a US residence for use by the shareholder. "Regular" Canadian corporations may still be useful for US estate tax planning for the purchase of a US residence, but there may be Canadian income tax implications for the shareholders if there is personal use of corporate property without adequate compensation to the corporation. Please consult your Canadian tax advisor.

Therefore some interest has shifted to the use of Canadian partnerships and Canadian trusts for US estate tax planning when purchasing a US residence for personal use. We summarized some of the provisions affecting partnerships in the last (Fall, 2005) Taxletter.

Trusts can be useful for many purposes. For example if you form an irrevocable trust that acquires a US residence and you do not retain certain "powers" over the trust, the property in the trust will not normally be subject to US estate tax on your death. (But see the articles ***"USE CAUTION WITH A "LIFE ESTATE" IN US REAL ESTATE"*** and ***"BEWARE GIFT TAX AND OTHER ISSUES WHEN USING TRUSTS".***

Part of the increased interest in the use of trusts vs. "regular" Canadian corporations (and even certain partnerships) stems from the potential US income tax advantage associated with the use of a trust vs. a corporation if the property is sold before death.

While the maximum US federal corporate income tax rate on real estate gains is 35%, the maximum federal income tax on long term capital gains earned by trusts may be limited to 15%. (Slightly higher for depreciation recapture). Additional State tax may apply.

Further, the distribution of the profit to the shareholder or beneficiary may attract additional tax in the case of the corporate shareholder but not (necessarily) in the case of the trust beneficiary.

However the US tax rules associated with real estate gains in trusts may be more complex than those associated with corporations and individuals. Thus there is the possibility of unexpected results and other surprises.

This Taxletter sets out some of these complexities in the aforementioned articles and also in the article ***"US TAXATION OF A US REAL ESTATE SALE BY A TRUST".*** However please consult your tax advisor before taking any action.

REVIEW OF US TAX RULES FOR US REAL ESTATE SALES BY NONRESIDENT ALIENS

Many readers are aware that if a nonresident alien sells US real estate for a profit there will likely be US federal income tax (capital gains tax) to pay. For individuals the tax is at graduated rates but, except for very large profits, the tax rate will not exceed 15% if you owned the property for more than one year. (25% on the portion representing depreciation recapture if the property was rental property or business property). If you did not own the property for more than one year the federal tax rate is graduated, subject to a maximum of 35%. State income tax may also apply.

Of course any permanent improvements are included in your "cost base" to determine your profit. Also you are entitled to deduct certain year of sale expenses such as real estate taxes, interest, insurance and maintenance, even if the property was personal use property.

The expression "income tax" is interchangeable with the expression "capital gains tax", in this context. The US does not have a "capital gains" tax per se. It has an "income tax" on "capital gains".

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There are two main components of the US tax matters when a nonresident alien sells US real estate.

1) The most important aspect is the fact you must file a US income tax return to report the sale and "settle up" on any US income tax owing to the IRS, (or refund due to you). The return is due by June 15th of the year following the sale (April 15th if you had wages subject to US withholding). The return is filed using IRS Form 1040NR.

2) The second aspect is the US withholding tax that applies at the time of sale as a prepayment of the above income tax. At the time of sale, 10% of the selling price will generally be withheld and sent to the IRS as a prepayment of your tax.

If this 10% withholding tax exceeds your US federal income tax as computed on your US federal income tax return, you will receive a refund of the excess from the IRS after filing the income tax return. (A State income tax return may also be required).

You will be exempt from the withholding tax (but not the income tax) if the buyer intends to use your property "as a residence" (and will sign an appropriate affidavit) and the selling price does not exceed $300,000.

Alternatively, if the 10% withholding tax exceeds your "maximum" tax, you can apply to the IRS on Form 8288-B to authorize a reduction in the withholding tax below 10%. Please see the article ***"US WITHHOLDING TAX ON US REAL ESTATE SALES BY NON-RESIDENT ALIENS"*** in the Fall, 2004, Taxletter for an explanation of these rules.

Unfortunately it may take the IRS three months or longer to respond to such an application, depending upon whether you previously obtained a US taxpayer identification number.

BEWARE US GIFT TAX AND OTHER ISSUES WHEN USING TRUSTS

As indicated elsewhere, there has been increased interest by nonresident aliens in the use of trusts (including "discretionary trusts") to purchase US residences.

We previously described some of the US gift tax risk when you purchase US real estate jointly with disproportionate financial contributions to the purchase price by each owner. A similar danger may arise when you add an additional owner to previously purchased US real estate.

The same risks may be present when you transfer US real estate to a trust, or purchase US real estate via a trust, unless:

1) The trust is a "grantor trust" taxed under the "grantor trust rules" as described in the article "***US TAXATION OF A US REAL ESTATE SALE BY A TRUST". (***Even in that case, the gift tax danger may be present if you later change the beneficiary of the trust), or

2) The transfer to the trust is not "complete", or

3) The transfer to the trust is a bona fide purchase by the trust, rather than a gift to the trust. (However certain purchases may not be "bona fide" (for this purpose) if the trust is funded as part of a pre-arranged plan to immediately purchase specified US real estate).

Completed Transfer

US gift tax only applies if there is a "completed gift". A gift in trust is only complete if you have reserved no power to change the disposition of the property. See Reg. 25.2511-2(b). Therefore a gift in trust is complete only if you have no power to:

1) Revoke the transfer,

2) Revest title to the property to yourself,

3) Name new beneficiaries, and

4) Change the interest of the beneficiaries, (unless the power is a fiduciary power limited by a fixed or ascertainable standard). (See Reg. 25.2511-2(c)).

The evaluation of whether a completed gift has occurred may be difficult when the trust contains complex provisions. In that case it may be necessary to have a tax attorney make the determination.

Gift of US Real Estate to a Trust

If you own US real estate and transfer it to a trust other than a trust taxed under the "grantor trust rules" the transfer may be characterized as either a gift or a sale, depending on the facts. Gift tax may potentially apply in either case. (See "***Purchase of US Real Estate by a Trust"*** below.

If you presently own US real estate and make a completed gift of the real estate to such a trust it is likely a taxable gift occurs. Generally the amount of the gift is the value of the interest in the real estate transferred.

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(Please see the article ***"USE CAUTION WITH A "LIFE ESTATE" IN US REAL ESTATE"***).

Unless the gift and the trust are subject to the rules of the "2503(b) Trust" or the "Crummey Trust" (referred to next), the net fair market value of the real estate transferred may be subject to gift tax at the tax rates in the US estate tax rate schedule, without any treaty benefits.

The "2503(b) Trust"

The tax code provides for annual gift tax exclusions for certain gifts. Nonresident aliens can generally make gifts of $12,000 per year (year 2006) to any number of recipients (donees) without triggering a taxable gift. (IRC 2503(b)).

To exercise this right but nonetheless maintain some control over the disposition of funds, the gift can be made via a "2503(b) Trust". With such a trust you can give property to children or other individuals, tax free (within the gift tax exclusion amount) while still maintaining some control over the funds – e.g. providing for separate income and remainder beneficiaries. The potential exclusion only applies to the income portion, not the remainder, and the income beneficiary must obtain a present interest in the gifted amount – i.e. the donee must have an unrestricted right to the income at the time of the gift. Please consult your tax advisor before taking any action.

The "Crummey Trust"

The "Crummey Trust" is a modification of the 2503(b) trust. It is also used to exploit the annual $12,000 exclusion but in a different way. Eligibility for the gift tax exclusion requires the beneficiary to receive a "present interest" in the gifted property. In this type of trust, annual contributions can be made to the trust in which the beneficiary has the right (generally for a limited time period) to withdraw all or part of the annual contributions to the trust.

Example: Oscar, a nonresident alien of the US resident in Canada, desires to make a gift of his $400,000 US condo to his nine children and grandchildren. He forms a Crummey Trust with each of his children and grandchildren as a beneficiary.

In May, 2006, he transfers one-quarter ($100,000) of the condo to the trust which contains the appropriate Crummey powers. If proper procedures are followed there is no gift tax since he is able to claim a gift tax exclusion of $108,000 (9 times the $12,000 exclusion available for 2006).

In January of each year from 2007 through 2009 he obtains a new appraisal of the property and, after being assured it has not appreciated in value, he transfers another quarter of the condo to the trust. Once again there is no gift tax since he is able to claim a gift tax exclusion of $108,000 (or possible higher amount, based on the inflation adjusted annual exclusion rate for those years). Thus the entire condo is transferred over approximately four calendar years.

Naturally if the property appreciates in value, the percentage of the property gifted each year must be adjusted to conform to the gift tax exemptions available for that year.

Please consult your tax advisor before proceeding.

Purchase of US Real Estate by a Trust

Alternatively the trust may purchase the real estate directly from a third party, or from you, in a bona fide purchase where the trust has been funded by you in advance to provide the necessary cash to make the purchase.

However in either case if you fund the trust with a gift of cash with the sole intent that the trust will immediately purchase specified real estate, it is possible the IRS would consider this tantamount to a gift of the real estate to the trust. In this case the IRS might levy gift tax as if you had simply made a direct gift of the real estate to the trust. (Again, this result would generally not apply if the trust is taxed under the "grantor trust rules"). See the article ***"US TAXATION OF A US REAL ESTATE SALE BY A TRUST".***

MORE ON COORDINATION OF CROSS BORDER TAX CREDITS ON REAL ESTATE SALES

We previously highlighted the potential difference in the tax reporting rules between Canada and the US when individuals resident in one country sell jointly owned real estate in the other country.

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US System (Some States)

For example, if Canadian resident spouses that are nonresident aliens of the United States sell jointly owned US real estate located in certain States (Florida for example) the profit is reported equally on each spouse's US income tax return unless a "tenants in common" deed with different allocations was in effect. Thus, (absent other factors), each spouse pays an equal amount of US income tax (capital gains tax) on the profit. This result occurs regardless of the proportion of the capital contributed by each spouse to purchase the property.

Canadian System

However on their Canadian income tax returns, each spouse will generally report his/her share of the profit based on the proportion of their respective contributions of capital to purchase the property. Thus if one spouse provided all the funds, that spouse will generally report all the profit and pay all the Canadian tax, subject to Canada's rules for foreign tax credits for the tax paid to the US. Therefore normally the contributing spouse will only get credit in Canada for the amount of US tax actually paid by him/her, (one-half the total). In this case the US tax paid by the other (non-contributing) spouse may not be available as a foreign tax credit in Canada.

Paragraph 15, of IT-270R3, issued by the Canada Revenue Agency (CRA) does provide that the US tax paid is generally apportioned to the Canadian spouses based on the relationship of the spouses' foreign income that gave rise to the foreign tax, rather than the amount actually paid by each spouse, if the spouses are filing a joint US income tax return. *However individuals that are nonresident aliens of the US throughout the year cannot file joint US income tax returns*!! Therefore only US citizens and US residents living in Canada and certain limited others (Please see the article "***TAX ELECTIONS TO BECOME A US RESIDENT FOR INCOME TAX***") will be eligible for this claim.

Article XXIV(2) of the tax treaty may be helpful, but as of February, 2006, no request for such a ruling had been made to the CRA.

In the situation described above it may be helpful to transfer the property solely to the contributing spouse before the sale. Where both spouses had contributed, but disproportionately, it may be appropriate to change the deed to "tenants in common". However in either case very complex gift tax rules apply - please consult your tax advisor before taking any action.

NONRESIDENT ALIENS AND US ESTATE TAX ON US "RICS" AND "REITS"

RICs

Readers are aware that nonresident aliens are subject to US estate tax on the shares of US corporations. Thus the shares of certain US Regulated Investment Companies (RICs) such as US corporate mutual funds, are included.

This rule applies regardless of where the mutual fund shares are purchased and held. For example it applies if the shares are purchased through a Canadian account, even if they are held inside an RRSP/RRIF.

However, the stock in the mutual fund will be exempt from US estate tax to the extent the underlying investments in the mutual fund would be exempt if owned directly by the nonresident alien. (Code Section 2105(d)).

Therefore in most cases the portion of the mutual fund represented by US public corporate and Government debt securities and all foreign (non-US) securities would be exempt. This could be helpful for nonresident aliens investing in US corporate mutual funds that are "balanced" funds, or funds investing all or part in overseas securities (e.g. "international" funds and "global" funds).

REITS

A Real Estate Investment Trust (REIT) may be organized as a corporation, trust, or association.

For those organized as trusts, apparently there is no clear guidance in the tax code or regulations regarding the application of the estate tax to the ownership of real estate investment trusts by nonresident aliens. However the IRS and the courts have often applied a "look through" rule similar to the new rule for RICs described above. Many REITs invest in mortgages. Thus, for example, if the mortgages qualify as "portfolio debt investments" under Code section 871(h),

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there is the potential for a full or partial exemption from estate tax on the REIT shares.

US TAXATION OF NONRESIDENT ALIENS RECEIVING "IRA" PENSIONS FROM THE US

The US has a vast array of pension plans available to individuals working in the US. One such plan, the "Individual Retirement Account" or "IRA" is somewhat similar to an RRSP but the deductible contributions are more limited and there is no carryforward of unused contribution amounts. Distributions must commence by April 1 of the year following the year in which you attain age 70 1/2. A penalty may apply, in addition to tax, if you make a withdrawal before age 59 1/2.

When an individual dies, the amount in the IRA is potentially subject to both US estate tax (on the total value of the account) and US income tax (on the deferred income in the account when a distribution is made). However a deferral may exist in the application of the estate tax if, for example, the IRA passes to a US citizen surviving spouse, or to a non-US citizen surviving spouse via a Qualified Domestic Trust.

Nonresident aliens of the US, resident in Canada, might own a US "IRA" because:

1) The individual worked in the US at one time, or

2) The IRA was inherited.

Nonresident Alien Individuals That Worked in the US

If you worked in the US, contributed to an IRA, and you make withdrawals from the account during your lifetime you are subject to US income tax on the withdrawals. For residents of Canada the US tax rate will normally be either 30% or 15% depending, respectively, upon whether the withdrawal is a "lump sum" withdrawal or a "periodic" withdrawal.

Unfortunately there is no definitive meaning of the word "periodic" in this context. Of course if you prorate and extend the payments over many years the payments likely qualify as "periodic". On the other hand if you withdraw the entire amount in one tax year it would be a "lump sum" withdrawal. There is no official guidance on how a prorated withdrawal over, say, three years, should be treated. Nonetheless the US tax rate (30% or 15%) may be unimportant if the amount is fully taxed in Canada and there is a tax credit in Canada for the US tax paid.

Estate Tax on Remaining Balance at Death. If you die before you have withdrawn the entire balance in the IRA account, your estate will be subject to US estate tax on the market value of the remaining value in the account.

Nonresident Aliens That Inherit IRAs

If you inherit an IRA from a deceased individual it will be necessary to ensure that US estate tax matters of the decedent have been addressed.

When you make a withdrawal from the IRA account it will be subject to either 30% or 15% US income tax, depending upon whether the withdrawal is a "lump sum" or "periodic" withdrawal, as set out above.

US "TRANSFER PRICING" RULES AND YOUR CROSS BORDER BUSINESS

For many Canadian or US businesses that have transactions with other entities that are "somewhat connected" to them, the "transfer pricing" rules may apply. The rules are dangerous because either Government (Canada or the US) may have the right to make a surprising re-allocation of profits between the entities.

This re-allocation is applicable to cross border transactions as well as domestic transactions. Therefore it can affect transactions between a Canadian corporation and a US corporation. This may commonly arise, for example, when a Canadian corporation sells it products or services through a US entity to which it has some form of connection other than a strictly "arm's length" connection.

In the US, Internal Revenue Code Section 482 authorizes the IRS to re-allocate income between otherwise unrelated entities in certain circumstances. The "circumstances" are not clearly defined.

The Code Section itself states the reallocation can be made "*in the case of two or more organizations…….whether or not organized in the United States, and whether or not affiliated*" (emphasis added) "*that are owned* (emphasis added) *or controlled by the same interests*".

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Thus, it is not simply a matter of whether or not one party owns 51% or more of the other party. The rules may apply in other circumstances as well.

Further, the Regulations state:

1) "The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted". (Reg. 1.482-2(3)), and

2) "The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses, owned (emphasis added*) or controlled directly or indirectly by the same interests"* (Reg. 1.482-2(4)).

In addition, apparently sections of temporary regulations issued in 1993 stated that "a presumption of control arises if income or deductions have been arbitrarily shifted as a result of the actions of two or more taxpayers acting in concert or with a common goal or purpose". (1993 Temp. Reg. 1.482-1T(g)(4)).

Thus it appears that "control" may exist even if the "controlling taxpayer" does not have a majority ownership interest or majority beneficial interest in the "controlled taxpayer".

When you are subject to the US transfer pricing rules you are required to use specified methods to determine the transfer price. You are also potentially subject to penalties for failure to adhere to a strict set of rules to document the procedures you used to determine the transfer price.

IRS FORMS FOR TAX FILING "EXTENSION" APPLICATIONS

In the US it is quite legal (and quite routine) to file a tax return or reporting Form after the due date, provided a valid extension of time to file is in effect. Although the US has penalties for late filing and late paying, as well as interest on the unpaid amount, the most significant penalty is often the late filing penalty. This penalty is avoided if a valid extension is in effect and the relevant return is properly filed within the extended period.

The IRS recently changed the extension application Form to be used for certain extension requests.

IRS Form 7004 must now be used instead of IRS Form 2758 for various extension requests including income tax returns for US estates, and IRS reporting Forms 1042, 3520-A, and 8804 (among others).

IRS Form 7004 must now also be used instead of IRS Form 8736 for various other extension requests including income tax returns for partnerships and US trusts (among others).

IRS Form 7004 must now be used for applications for "Additional Extension of Time" for various other extension requests including income tax returns for partnerships and US trusts (among others).

IRS Form 7004 continues, as before, to be used to obtain an extension to file US income tax returns for domestic and foreign corporations.

In all cases above, filing a valid IRS Form 7004 provides a six month extension of the due date for the return.

US TAXATION OF A US REAL ESTATE SALE BY A TRUST

The US tax law applicable to the taxation of trusts and their beneficiaries is very complex. The concepts described here are a very brief summary of a very extensive set of rules. For example, special rules may apply to you if you are a US person resident in Canada and you make a transfer to a Canadian trust that has a US beneficiary. This rule may affect you even if you do not become a US person until five years later. Many other complex and treacherous rules apply. Please take action only on the basis of advice provided directly to you by your tax advisor.

Trusts are classified as grantor trusts or non-grantor trusts, and the latter are classified as simple trusts or complex trusts (please see Exhibit 1).

The US tax rules applicable to a trust that sells its US real estate for a capital gain depend upon numerous factors, including:

1) Whether the trust is a domestic (US) trust or a foreign trust,

2) The type of trust involved (grantor or non-grantor, simple or complex),

3) Whether the proceeds of the sale are distributed within the tax year of the sale,

4) Whether the beneficiary is US person or a non-US person, and

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EXHIBIT 1

General Rules For US Taxation Of Trusts That Are Taxed As "Non-Grantor" Trusts (1)

Definitions

Simple Trusts

1) The Terms Require All ***FAI*** To Be Distributed Currently And
2) Cannot Provide For Charitable Purposes, And
3) Must Not Distribute Any Amount During The Year Other Than The FAI Required To Be Distributed Currently(IRC 651(a)).

Complex Trusts

Any Trust That Is Not A Simple Trust.

Taxation Of The Trust

Simple Trusts

1) A Deduction Is Allowed For All Trust Income That Is Required To Be Distributed, But Limited To ***DNI***
2) No Deduction For Distribution Of Net Tax Exempt Income (IRC 651(b)).

Complex Trusts

1) A Deduction Is Allowed For All Trust Income That Is Required To Be Distributed Currently, And Any Other Amount Properly Paid Or Credited Or Required To Be Distributed For The Tax Year, But Limited To DNI (IRC 661(a)).
2) No Deduction For Distribution Of Net Tax Exempt Income, Or Certain Other Income Not Included In The Trust's Gross Income.

Taxation Of The Beneficiary

Simple Trusts

1) Taxable On Allocable Share Of Trusts Distribution Deduction, (To The Extent Of DNI), Even If Not Received (Reg. 1.652-(a)(1)).
2) Income Items Retain Their Character (IRC 652(b)).

Complex Trusts

1) Taxable On Allocable Share Of Trust's Distribution Deduction, Even If Not Received (IRC 662(a)). However Specific Bequests And Charitable Distributions Are Not Subject To This Rule (IRC 663(a)).
2) Income Items Retain Their Character (IRC 662(b)) Except For Certain Accumulation Distributions By Foreign Trusts To US Persons.
3) "Throwback" Rules Apply To Foreign Trusts And Certain Domestic Trusts.

FAI – Fiduciary Accounting Income Is A State Law Concept. It Is Determined Under The Terms Of The Governing Instrument And Applicable Local Law. Thus Items Such As Interest, Dividends, And Rents Are Generally Allocated To Income, (FAI) And Gain From The Sale Of Trust Assets Are Generally (But Not Always) Allocated To Trust Principal (Corpus).

DNI – Distributable Net Income Is A Federal Tax Concept. It Is The Taxable Income Of The Trust, Calculated By Excluding The Distribution Deduction, The Exemption Amount, And Capital Gains (Assuming The Latter Are Allocated To Corpus), Unless The Capital Gains Are Paid, Credited, Or Required To Be Distributed To A Beneficiary. In The Case Of Simple Trusts, Extraordinary Dividends And Certain Stock Dividends Are Allocable To Corpus And Therefore Also Excluded From DNI.

FAI May Differ From DNI Due To, For Example, The Exemption Amount, The 2% Limit On Certain Deductions, And The Fact That Trustee's Fees Under Most State Laws Are Allocable One-Half To Corpus And One-Half To Income But Are Generally Deductible In Full For Tax Purposes To The Extent They Not Associated With Tax Exempt Interest.

(1) This Is An Oversimplified Summary Of A Complex Set Of Rules.
Please Contact Your Tax Advisor Before Taking Any Action.

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5) In the case of a non-grantor foreign complex trust, whether or not there is an "accumulation distribution".

"Domestic" Trust vs. "Foreign" Trust

A domestic trust is any trust if:

1) A court within the United States is able to exercise primary supervision over the administration of the trust, *and*

2) One or more U.S. persons have the authority to control all substantial decisions of the trust.

Any other trust is a foreign trust.

Grantor Trust vs. Non-Grantor Trust

If a trust is a "grantor trust" the income of the trust might be taxed under the "grantor trust rules".

"Grantor" Defined. A "grantor" includes any person to the extent such person either created a trust, or directly or indirectly makes a gratuitous transfer of property to the trust. If a person creates a trust on behalf of another person, both persons are treated as "grantors" of the trust. (Reg. 1.671-2(e)(1)).

"Grantor Trust" Defined. Simplistically, a grantor trust generally is a trust that is controlled by the individual that created and transferred property to the trust, or is a trust that is treated as owned, all or in part, by other persons, under "ownership' rules set out in the tax code. See Code Sections 671-679. Under Code Section 679, for example, if a US citizen (or green card holder) living in Canada transfers property to a Canadian trust that has another US citizen, or green card holder, or other US resident as a beneficiary the transferor may be subject to tax on the income of the trust even if he/she has no power over the trust.

"Grantor Trust Rules". Under the grantor trust rules, a grantor trust's income is generally taxed to the "grantor" or other person that has certain ownership characteristics in the trust as described in Code Section 678. In this case, the trust is not subject to income tax, and is not even a taxable entity for income tax purposes

The "grantor trust rules" only apply to the extent it results in income being taken into account in computing the income of a US citizen or US resident or a domestic corporation. (IRC 672(f)(1)). Thus, the "grantor trust rules" may only apply partly, or not at all, to a trust that is otherwise a grantor trust, but has a foreign grantor. But an important exception to this Section 672(f)(1) rule applies to the extent the grantor has certain powers to "revest" the title to the trust property back in the name of the grantor, or to the extent amounts can only be distributed to the grantor or his/her spouse. (IRC 672(f)(2)).

Most commonly, a grantor trust is a trust created by an individual during his/her lifetime and it is a trust that the same individual can terminate at any time (i.e. it is "revocable").

The sale of US real estate by a grantor trust that is taxed under the "grantor trust rules" is treated as the sale of real estate by the "grantor" (that is normally an individual). In this case the rules for the sale of real estate by an individual apply to the sale by the trust.

If a trust is a "non-grantor" trust, the trust is a taxable entity. Its income is taxed to the trust, the beneficiaries, or a combination thereof.

Thus the remainder of this article will only apply to:

1) Non-grantor trusts, (including cases where a grantor trust becomes a non-grantor trust as a result of the death of the grantor), and

2) Grantor trusts where the "grantor trust rules" do not result in income being taken into account in computing the income of a US citizen or resident or a domestic corporation. (Per IRC 672(f)(1) mentioned above and after considering 672(f)(2)).

The above will be collectively referred to as "non-grantor" trusts.

"Simple" Trusts vs. "Complex Trusts

Non-grantor trusts and their beneficiaries are taxed differently depending upon whether the trust is a simple trust or complex trust. Please see Exhibit 1.

A simple trust is a trust:

1) Whose terms:
   - a) Require all "income" to be distributed currently, and
   - b) Do not provide for charitable purposes, and

2) That does not distribute any amount during the year other than "income" that is required to be distributed currently.

Any trust that is not a simple trust is a complex trust.

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Taxation of Non-Grantor Trusts in General

The "earnings" of a trust are allocated to, (i.e. "treated as"), either "income" or principal ("corpus") of the trust depending on:

1) The terms of the governing trust document, and

2) Local law.

Unless overridden by other rules, the beneficiary (ultimately) pays the tax on earnings allocated to "income" and the trust pays the tax on earnings allocated to "corpus". If the earnings are validly allocated to corpus and taxed to the trust, a subsequent distribution of these earnings to beneficiaries will generally be considered a tax-free distribution of capital to the beneficiaries. An exception may apply in the case of an "accumulation distribution" by a foreign trust to a US person.

Under governing trust documents and local law it is common for interest, dividends and rents to be allocated to "income" (referred to as "Fiduciary Accounting Income" or "FAI") and for capital gains to be allocated to "corpus". (See Reg. 1.643(b)(-1)).

A trust is subject to tax on all its income (except for example municipal bond interest) but certain deductions are allowed in the computation of its US income tax liability. One of the most important deductions is the "distribution deduction" - i.e. the allowable deduction for distributions made to beneficiaries (including, in certain cases, amounts required to be distributed to beneficiaries, and even certain other amounts described below).

However the amount of the "distribution deduction" is limited to the trust's "distributable net income", or "DNI". In general, DNI is the trust's taxable income calculated by excluding the "distribution deduction", the exemption amount, and (in certain cases) capital gains.

Taxation of US Real Estate Gains Earned by a Non-Grantor Domestic Trust

SIMPLE TRUSTS

Gain is Taxed To the Trust. As indicated above, capital gains are normally allocated to "corpus" rather than "income" and not included in DNI, and thus taxed to the trust rather than the beneficiary.

In this case, if the gain is a short term capital gain it is subject to graduated rates that quickly rise to 35% on taxable income is excess of $10,050. (Code Section 1(e)). Under Code Section 1(h), if the gain is a long term capital gain taxed to the trust the tax rate is limited to 15% (25% on depreciation recapture). Alternative minimum tax (AMT) may also apply. Thus, if you are a beneficiary and you receive a distribution of gain from such a trust it is generally a tax-free distribution of capital to you. (IRC 652(a)).

Gain is Taxed to the Beneficiary. On the other hand, if the governing instrument and local law allocate capital gains to "income" (rather than "corpus") the trust receives a "distribution deduction" (to the extent of DNI) for the real estate gain and the gain is not taxed to the trust. (IRC 651(a)). In this case gains are allocated to DNI. (Reg. 1.643(a)-3(b)(1)).

In this scenario, the beneficiary is taxed on the gain in the year it occurs, regardless of whether it is distributed to the beneficiary. (IRC 652(a).

Generally the distributions have the same character as they had in the hands of the trust. (IRC 652(b)). Short term capital gains (real estate held 12 months or less) are taxed to individuals at graduated rates up to 35% federally. Long term real estate gains are taxed to individuals at a maximum 15% federally (subject to a 25% rate for recaptured depreciation). AMT may also apply.

COMPLEX TRUSTS

Gain is Taxed to the Trust. The rules for complex trusts are, as expected, more "complex"!

In general, if capital gains are allocated to corpus under the governing instrument and local law, and not distributed or required to be distributed they will be taxed to the trust. In this case a distribution of the gain to the beneficiary will be treated as a tax-free distribution of corpus. However very important exceptions may apply. See "**Gain is Not Taxed to the Trust**", next.

Gain is Not Taxed to the Trust. On the other hand, the trust will receive a "distribution deduction" *(to the extent of DNI)* for the sum of:

1) Any amount of "income" (as distinguished from "corpus") for such year

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required to be distributed currently, (including any amount required to be distributed which may be paid out of "income" or "corpus" to the extent such amount is paid out of "income" for the year), and

2) Any "other amounts" properly paid or credited or required to be distributed for such year. (IRC 661).

For a non-grantor domestic trust, real estate capital gains *are included in DNI* (and thus the trust actually receives the "distribution deduction" mentioned above) to the extent the gains are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary:

1) Allocated to "income", or

2) Allocated to "corpus" but treated consistently by the fiduciary on the trust's books etc. as part of a distribution to a beneficiary, or

3) Allocated to "corpus" but actually distributed as capital gains to the beneficiaries during the year, or used in determining the amount which is distributed or required to be distributed during the year, or

4) Irrevocably paid or set aside for certain charitable purposes. (See IRC 643(a)(3), and Reg. 1.643(a)-3(b)).

Beneficiary's Tax Position. If the trust is entitled to a distribution deduction (as described above and under Code Section 661(a)), that amount is taxable to the beneficiary to the extent of the sum of the following amounts:

1) Amount required to be distributed currently, whether distributed or not, and

2) All other amounts properly paid, credited or required to be distributed for the taxable year (IRC 662(a)).

Via careful tax planning you may be able to influence whether it is the trust or the beneficiary that is taxable, thus taxing it to the party that has losses available or a lower marginal tax rate. However the rules are complex, please consult your tax advisor before acting.

Generally the character of the distributions have the same character as they had in the hands of the trust. (IRC 662(b)).

Taxation of US Real Estate Gain By Non-Grantor Foreign Trust

The rules for the US taxation of US real estate gains by a non-grantor foreign trust are similar to those for the taxation of a non-grantor domestic trust. However three major differences are:

1) The Throwback Rule. Please see "***Foreign Trusts and the "Throwback" Rule"***, below),

2) Capital Gains Treatment and DNI. Unlike domestic trusts, in the case of a non-grantor foreign trust, a real estate capital gain is automatically considered part of DNI regardless of whether it is allocated to income or corpus under the governing instrument or local law, and regardless of whether or not it is distributed.

(IRC 643(a)(6)(C) and Reg. 1.643(a)-6(a)(3)(iii)), and

3) The Character of Distributions. See "***Character of Distributions***" below.

For purposes of its tax filing, a foreign trust is treated as a nonresident alien that did not reside in the US at all during the year. (IRC 641(b)). Thus the trust files IRS Form 1040NR.

SIMPLE TRUSTS

Since capital gains earned by a foreign trust are always included in DNI, a beneficiary of a non-grantor foreign simple trust will be taxable on the US real estate gain to the extent it is allocable to "income" rather than corpus" under the governing instrument and local law. Otherwise it is taxable only to the trust.

COMPLEX TRUSTS

Similarly, since capital gains earned by a foreign trust are always included in DNI, a beneficiary of a non-grantor foreign complex trust will be taxable on the US real estate gain currently to the extent of:

1) Any amount of "income" (not "corpus") required to be distributed currently, whether distributed or not, and

2) Any "other amounts" properly paid, credited or required to be distributed for the taxable year. (IRC 661(a)).

To the extent it is not taxable immediately to the beneficiary it will be taxable to the trust. However in this case it may later be taxable to the beneficiary under the "throwback rule" when there is an "accumulation distribution". The concepts of "accumulation distribution" and "throwback rule" generally only apply to foreign trusts and a very limited class of domestic trusts.

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Foreign Trusts and the "Throwback" Rule

Certain foreign trusts (but generally not domestic trusts formed after February 29, 1984 that were always domestic trusts) are potentially subject to a "throwback" rule. In this case the beneficiary will be subject to tax on earnings previously subject to tax in the trust, but only if the beneficiary's tax would be higher than the trust's tax.

Under this rule, there is an additional tax to the beneficiary on distributions, based on the average increase in the beneficiary's taxable income that would have occurred if the accumulated amount had been taxable to him/her in prior years, rather than the exact increase in tax paid during the years the income was accumulated in the trust. The beneficiary receives a credit for tax paid by the trust. An interest charge is also levied.

The throwback rule applies whenever the trust:

1) Makes an "accumulation distribution" during one taxable year, and

2) Had "undistributed net income" ("UNI") in one or more of its "preceding taxable years".

An "accumulation distribution" for any taxable year is the amount by which:

1) The amounts specified in Code Section 661(a)(2) for the taxable year – (i.e. "any other amounts properly paid or credited or required to be distributed during the taxable tax year") - exceed

2) The DNI for such year, limited by the amounts specified in code section 661(a)(1) - i.e limited by "the amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus, to the extent such amount is paid out of income for such taxable year". (IRC 665(b)).

Therefore, simplistically, a foreign trust makes an accumulation distribution in any year in which the trust distributes more than its current year's DNI, if the trust has "UNI."

"UNI" for any year is the amount for the year by which the DNI of the trust for the taxable year exceeds the sum of:

1) The amounts of income required to be distributed currently, and

2) Certain other amounts properly paid or credited or required to be distributed for such taxable year (i.e. to the extent the DNI exceeds the totals of the amounts specified in code sections 661(a)(1) and (2)), less any taxes imposed on the trust attributable to such DNI. (IRC 665(a)).

Simplistically, to the extent that less than all of the trust's DNI is paid out during the year, (or during the 65 day period after the end of the year), the portion of the DNI that is not paid out becomes UNI. UNI can be subject to unfortunate treatment in addition to the throwback rule. See "**Character of Distributions**" next.

Character of Distributions

If a real estate gain is distributed by a foreign trust to a US beneficiary and taxed to the beneficiary in a year later than when it is earned, its character may change from capital gain (potentially taxed at a 15% rate in the trust) to ordinary income taxed at up to 35% to the beneficiary, plus the interest charge described in the "throwback rule".

However if capital gain is distributed by a foreign trust to a nonresident alien beneficiary in a year later than when it is earned, its character will remain as it was in the trust. (IRC 667(e)). Therefore if the trust's gain was long term it will still be taxed as a long term gain to the nonresident alien.

As stated at the outset, all the rules are far more extensive and complex than expressed in this oversimplified summary. Please contact your tax advisor before taking any action.

Also, for a more detailed review of this subject please refer to an excellent Portfolio written by international tax attorney Thomas St. G. Bissell, Esq., tel. 201-444-6721. (Portfolio #944 issued by Tax Management Inc., a BNA Company).

RBC CENTURA (ROYAL BANK) OFFERS UNIQUE SERVICES IN THE US

RBC Centura Bank (the US affiliate of the Royal Bank of Canada) provides some helpful services to Canadians in the US. These may be helpful whether you are a tourist, a snowbird, have business connections in the US, or are a US resident with Canadian ties.

Any Royal Bank branch in Canada can facilitate the opening of an account with RBC Centura in the US.

As an account holder with RBC Centura you can access an extensive network of ATM

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machines in the US. If you are seeking a mortgage in the US you can apply directly to RBC Centura and/or you can arrange for your Canadian credit history to be available for a mortgage application or credit card application in the US.

For personal bank accounts you can arrange for online transfers of funds between your Royal Bank account in Canada and your RBC Centura bank account in the US with RBC unique cross border online capability.

The online banking arrangement even permits you to have Canadian pension payments including CPP/QPP and OAS to be deposited in your US RBC Centura bank account.

For more information call RBC Centura Bank at 561-362-7950.

TAXATION OF INCOME FROM REITs

The taxation of Real Estate Investment Trusts (REITs) and their owners can be complex – please consult your tax advisor before taking any action. A REIT can be a corporation, trust, or association.

A REIT is entitled to a deduction for dividends it pays to its owners. Thus the REIT may be subject to no income tax at all if it distributes the appropriate amount of income. In some cases the REIT may be able to declare a dividend in one taxable year and get a deduction in that taxable year, even though the dividend is not received by owners and not taxable to owners until the following year. (IRC 858).

Among other requirements to qualify as a REIT, the entity's gross income must be at least 95% derived from –

- interest,
- dividends,
- rents from real estate,
- gain from securities or real estate, and
- certain other limited sources.

and generally at least 75% of its gross income must be derived from –

- rents from real estate,
- mortgage interest on real estate,
- gains from real estate and real estate mortgages,
- dividends, gains, etc., from other REITs, and
- certain other limited sources.

The REIT must generally distribute at least 90% of its taxable income (excluding capital gain net income).

To qualify as a REIT many other requirements must also be met, including the composition of the assets of the entity at the close of each quarter of the taxable year.

General Income Tax Rules

The US taxation of distributions from REITs is similar to the taxation of distributions from corporations – i.e. the distribution is treated as ordinary income, to the extent of current or accumulated earnings and profits, (with an exception for certain capital gain dividends). However ordinary dividend distributions from REITs generally are not "qualified dividends" for purposes of the 15% maximum tax on qualified dividends, except to the extent the REIT itself is subject to tax. (IRC 857(c)(2)).

Capital gain dividends paid by REITs are treated as "long term" capital gains by the recipients even if the recipient owned the interest for less than one year. (IRC 857(b)(3)(B)). However the offset is that a capital loss on the sale of the ownership interest might be required to be treated as a long term capital loss even if the interest was held for less than a year. (See IRC 857(b)(8)(A)).

Owners are taxed on undistributed capital gains of the REIT, to the extent designated by the REIT but are entitled to claim a "deemed tax paid" based on the tax thereon paid by the REIT.

Taxation of Nonresident Aliens Resident in Canada

Ordinary Dividends. Canadian individuals receiving "ordinary" dividends from a REIT are generally subject to the 15% tax treaty rate on dividends from REITs.

Real Estate Capital Gain Dividends. In the case of a dividend representing a distribution of capital gain from real estate a recent change in the law provides that the distribution will generally no longer be treated as the receipt of real estate gain by nonresident aliens if the REIT was publicly traded and the shareholder did not own more than 5% of the stock. (IRC 897(h)(1)). Instead, the distribution will be treated as a dividend. (IRC 857(b)(3)(F). This eliminates the need for nonresident aliens to file US income tax returns due to the receipt of the real estate gain (provided the proper tax is withheld on

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the dividend). It also limits the tax to the 15% treaty rate, and eliminates the branch tax in the case of corporate recipients.

Sale of REIT Shares. A capital gain from the sale of an investment in a domestically controlled REIT is not subject to US tax, assuming the investment is not connected with US business. (IRC 897(h)(2)).

US ESTATE TAX EXAMPLES FOR NONRESIDENT ALIENS

For many nonresident aliens that are resident in Canada, US federal estate tax has now become somewhat irrelevant (i.e. the tax liability itself is zero) due to the changes in US estate tax rules and the overlay of the benefits of the Canada-US tax treaty. However, attempting to evaluate your exposure to estate tax can be difficult because of the complexity of the rules.

For many individuals, the key is the computation of the "unified tax credit" (see below).

If you are a nonresident alien resident in Canada, the general rule to compute your US federal estate tax exposure for deaths after 2004 is as follows (assuming there were no prior taxable gifts):

1) Compute the "taxable estate". To compute this you determine the "US property" subject to tax, and deduct the appropriate pro-rata amounts for debts, expenses, and charitable contributions. Special deductions apply to property passing to a US citizen surviving spouse or to a nonresident alien surviving spouse via a "qualified domestic trust".

2) Compute the "tentative estate tax" on the "taxable estate" using the appropriate tax table in the Internal Revenue Code.

3) Compute the so-called "unified tax credit" and deduct it from the "tentative estate tax". The tax code sets out a "unified tax credit" that is available to decedents that are US citizens or US domiciliaries. Nonresident aliens that are resident in Canada are entitled to a proportion of this unified tax credit based on the proportion of their worldwide assets that are subject to US estate tax.

4) Compute the "marital tax credit" (if any) and deduct it from the remaining tax in 3. above. The net result will be the federal estate tax exposure for the year chosen, based on present law. Very simplistically, the marital tax credit is equal to the unified tax credit, provided all the taxable US property passes to the surviving spouse. Of course it is limited to the remaining tax due after application of the unified tax credit. Separate eligibility requirements apply for the marital tax credit and there is an important deadline for claiming it.

Exhibit 2 sets out just a few examples of the result of these calculations based on the assumptions provided. The examples also assume there are no other tax factors involved other than those listed. Only federal estate tax is shown. Some States (but not Florida) levy a separate additional estate tax.

Of course in actual situations there may be many relevant factors that are not considered here. Please consult your tax advisor before taking any action.

TAX ELECTIONS TO BECOME A US RESIDENT FOR INCOME TAX

The expression "US resident" is used in both the US immigration and US income tax contexts. However the meaning in each context can be substantially different. For example it is possible for an individual to be a US resident for US income tax purposes but not for immigration purposes. Thus an individual can be subject to US income tax as a resident even if he/she does not even have the right to live in the US. (For example, please refer to the "substantial presence test").

Further confusion may arise in a year when an individual moves between Canada and the US, or in a year when an individual resident in one country works temporarily in the other country. Even more complexity may arise in the case of married spouses where only one of them works temporarily in the US while the other remains working back in Canada.

In the US, married individuals may file separate income tax returns, but certain married individuals may file a joint tax return instead. Joint returns are often preferable because it may result in a lower tax liability. Thus, for example, if you are a nonresident alien moving to the US, or back to Canada, or if one spouse worked in the US temporarily, it may be desirable to evaluate whether filing a joint US income tax return would be preferable for that year. If you file a joint return it must report the worldwide income of both spouses for the entire year.

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EXHIBIT 2

Some Examples Of Exposure To US Estate Tax For Nonresident Aliens Resident In Canada (1)

US PROPERTY SUBJECT TO TAX	*WORLDWIDE PROPERTY*	*YEAR OF DEATH*	*US ESTATE TAX BEFORE TAX CREDITS*	*POTENTIAL UNIFIED CREDIT*	*POTENTIAL NET TAX IF NO SURVIVING SPOUSE*	*(POTENTIAL) MARITAL CREDIT IF A SURVIVING SPOUSE EXISTS*	*(POTENTIAL) NET TAX IF ALL US PROPERTY PASSES TO A SURVIVING SPOUSE*
500,000	3,900,000	2006-2008	155,800	100,103	***55,697***	55,697	***0***
500,000	5,000,000	2006-2008	155,800	78,080	***77,720***	77,720	***0***
500,000	7,500,000	2006-2008	155,800	52,053	***103,747***	52,053	***51,694***
750,000	4,500,000	2006-2008	248,300	130,133	***118,167***	118,167	***0***
750,000	7,500,000	2006-2008	248,300	78,080	***170,220***	78,080	***92,140***
750,000	10,000,000	2006-2008	248,300	58,560	***189,740***	58,560	***131,180***
1,000,000	4,500,000	2006-2008	345,800	173,511	***172,289***	172,289	***0***
1,000,000	10,000,000	2006-2008	345,800	78,080	***267,720***	78,080	***189,640***
1,000,000	12,000,000	2006-2008	345,800	65,067	***280,733***	65,067	***215,666***

(1) Assumes There Are No Tax Factors Other Than Those Listed. See The Article ***"US Estate Tax Examples For Nonresident Aliens."*** Assumes Decedent (And Surviving Spouse, If Applicable) Are Nonresident Aliens. The Determination Of "US Property Subject To Tax," And "Worldwide Property" Can Depend On The Proportion Of Contribution In The Case Of Jointly Owned Property. The Law May Change At Any Moment.

This Is A Summary Of A Few Examples Only. Many Exceptions Apply. Please Consult Your Tax Advisor Before Taking Any Action.

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Example: Max and Silvia are married Canadians. Neither is a US citizen and neither has been a US resident, except in 2005 Silvia was sent temporarily to the US by her new Canadian employer and lived and worked full time in the US from April 1, through December 31. (She was unemployed from January 1, 2005, to April 1, 2005).

On January 1, 2006, Silvia returned to live and work in Canada. Max remained living and working full time in Canada throughout 2005. For calendar year 2005 Silvia earned $150,000 and Max earned $80,000.

Ignoring all tax factors involved other than the figures above, and assuming neither spouse had any other income, the US federal tax liability for Silvia for 2005 would be approximately as follows, depending on which type of return she filed:

	US Tax
Silvia filing a separate US return	$36,034
Silvia filing a joint return with Max (1)	27,140
Approximate US tax savings by filing a joint return	$8,894

(1) Assuming, as expected, Max's income qualified for the foreign earned income exclusion.

However joint returns can only be filed if you qualify. If either spouse was a nonresident alien at any time during the year, it will be necessary to make a special election to qualify for the joint return. However you must, in turn, qualify to make the election! Please see Exhibit 3.

The regulations describe the procedure to make the election and the implications. In some cases the election remains in effect until revoked, and if revoked there are restrictions on future elections.

USE CAUTION WITH A "LIFE ESTATE" IN US REAL ESTATE

A nonresident alien may have a desire to transfer a US vacation residence to an adult child (or an irrevocable trust) but may be reluctant to give up use of the property.

Readers are aware this can be accomplished by transferring the property to the child (or trust) while retaining a "life estate" in the property. The life estate entitles the transferor/parent to use the property for the remainder of his/her life. The life estate is recorded on the deed to the property that is filed in the County property records. The deed also indicates that the child (or trust) has the "remainder interest" in the property. Thus, the child or trust becomes the sole owner when the transferee/parent dies, or surrenders the life estate.

One benefit of undertaking this transaction is the possibility of avoiding US court probate with respect to the property on the death of the transferor/parent, since his/her interest in the property is completely extinguished upon death.

However unless the transaction is entered into with full knowledge of the Canadian and US tax ramifications, the transaction may be "too good to be true".

US Gift Tax

For example, if the transfer is accomplished by way of a gift of the "remainder interest" to the child or trust, it is possible a US taxable gift has occurred. The amount of the gift (i.e. the value of the remainder) would be determined, in part, from indexes in an IRS table based on the age of the transferor/parent. The US gift tax could be more severe than US estate tax because, although the same tax rate schedule is used for both estate tax and gift tax, the tax treaty does not provide for any gift tax exemptions or credits as it does for estate tax. Of course if a child genuinely purchases the remainder interest at market value, with his/her own funds, a gift would not have occurred.

US Estate Tax

Unfortunately the estate tax rules provide that if you transfer property but retain a "life estate", the full value of the property will still be subject to US estate tax when you die, (unless you previously surrendered the life estate – which may also result in gift tax). (IRC 2036). An exception applies if the transfer was a "bona fide" sale for an "adequate and full consideration in money or money's worth".

Modified Alternatives

Enhanced Life Estate. In the Winter/Spring, 2005, issue of the Taxletter we described the concept of "enhanced" life

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estates. In this scenario the transferor may not technically make a taxable gift, even if the child pays nothing for the remainder interest. Thus the gift tax may be avoided, and the probate benefits may be achieved, but the full value of the property would likely be subject to US estate tax.

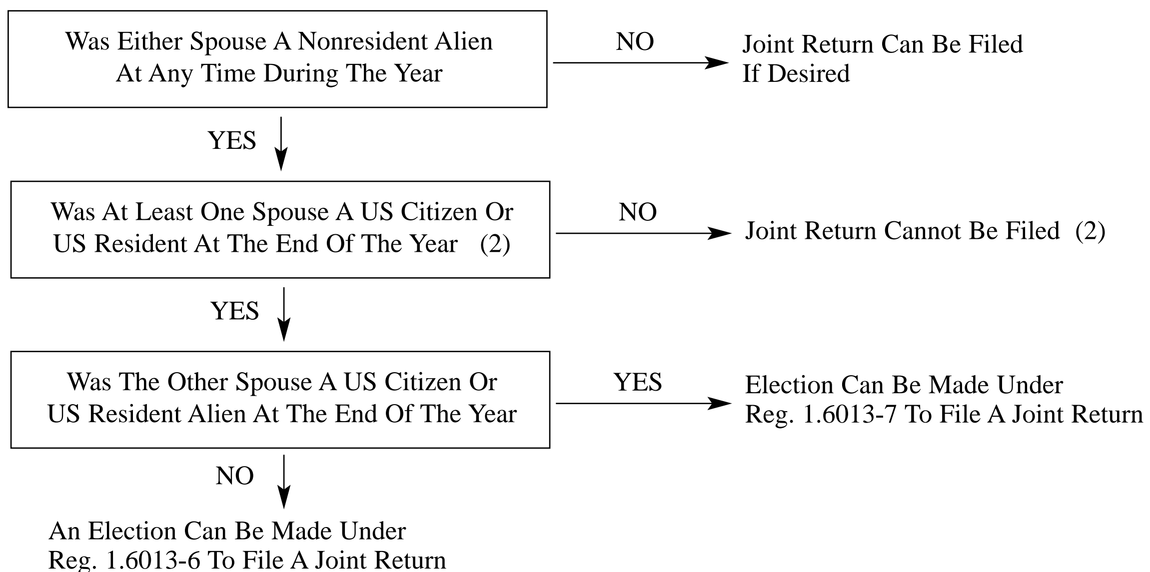
Installment Sale. To attempt to avoid the gift tax and the estate tax, the transferor/parent may decide instead to "sell" the entire interest to the child via an "installment gift" transaction. In this scenario the parent would sell the property to the child for fair market value, but would assist the child in financing the purchase by taking back "installment notes" for the purchase price. It may be the intent of the parent to periodically cancel (forgive) a portion of the notes based on the amount provided for under the annual gift tax exclusion. ($12,000 per recipient (donee) commencing in 2006).

In Revenue Ruling 77-299 the IRS ruled that when the forgiveness of the notes is part of a "prearranged plan" the IRS will consider the transfer of the property a "disguised gift" rather than a "bona fide" sale. The Tax Court has disagreed with this - but the IRS has "nonacquiesced" in the decision. (e.g. Kelly Estate v. Comr, 63 TC 321). Notwithstanding this IRS position, some commentators question whether it is even possible for a present intent to make a future gift, to constitute a present gift. (See Revenue Ruling 69-346).

In any event, the IRS appears to have agreed that if the donor does not have a pre-arranged plan to forgive the notes, a (tax-exempt) gift would only occur each year as each note is forgiven. (Revenue Ruling 81-264).

EXHIBIT 3

Eligibility Requirements For Individuals That Are Married At Year End To File A Joint US Income Tax Return (1)



(1) Only Individuals Married At Year End Can File A Joint Return.

(2) If Neither Spouse Is A US Citizen Or Resident Alien At The End Of The Year, One Or Both May Be Eligible To Make An Election To Be A Resident At The End Of The Year.

Under Reg. 301.7701(b)-4(c)(3), If You Are A US Resident For The Following Year, You Can Make An Election To Be A Resident For The Tax Year If:
A) You Were Present In The US For At Least 31 Days In A Row During The Tax Year, And
B) You Were Present In The US In The Tax Year For At Least 75% Of The Number Of Days Beginning With The Earliest 31-Day Period That You Use To Qualify. You Are Treated As A US Resident For The Remainder Of That Year.

Caution: Each Election Has Special Rules, And Implications For Future Tax Years. Please Consult Your Tax Advisor Before Taking Any Action.

THE INFORMATION HEREIN IS PROVIDED FOR YOUR GENERAL INFORMATION. ACTION SHOULD NOT BE TAKEN ON THE BASIS OF THIS LETTER. ACTION SHOULD ONLY BE TAKEN ON THE ADVICE OF YOUR PROFESSIONAL ADVISOR APPLYING THESE RULES TO YOUR SPECIFIC SITUATION.

Self-Canceling Notes ("SCINS"). A further variation may apply if the property is sold to the child for fair market value via a note that self-cancels on the death of the parent before all payments have been made. Unfortunately any self-cancellation feature likely reduces the value of the note (i.e. the consideration paid by the child for the property) and therefore may trigger gift tax at the time of the sale.

A separate additional issue may arise due to the self-cancellation feature. Normally the real estate will have appreciated at the time of "sale" to the child. At some point this appreciation is subject to US income (capital gains) tax. Under the US rules the taxation of the gain can be deferred until the note is paid. What effect does the death of the note holder have on this rule?

While normally a disposition of an installment obligation triggers income tax to the seller (the parent in this case) a separate US rule applies when the seller dies. In this latter case it is the estate of the decedent rather than the decedent that is subject to the tax even though the note was cancelled. (See Revenue Ruling 86-72). This may prevent a foreign tax credit being claimed on the decedent's final Canadian income tax return for the US income tax triggered on the decedent's estate.

LLCs AND US TAX ACCOUNTING

Individuals resident in Canada generally may not want to use a US Limited Liability company (LLC) for their US business or investments because the entity may be treated as a corporation for Canadian income tax purposes. In this case there may be a mismatching of income and tax credits between countries unless all earnings are distributed within each tax year.

However if an LLC is used, the issue arises as to whether the entity may use the "cash" method of accounting for its US income tax return or whether it must use the "accrual" method. Generally, the accrual method of accounting must be used for "tax shelters". (Code Section 448(a)(3)).

The expression "tax shelter" is defined in Sections 448(d)(3), and 461(i)(3). Among other circumstances, a tax shelter means any "syndicate". A "syndicate" for this purpose is any partnership or other entity (other than a corporation that is not an "S" corporation) if more than 35% of the losses are allocable to "limited" partners or limited entrepreneurs. (IRC 1256(e)(3)(B)). There are exceptions for holdings attributable to active management.

Apparently there is uncertainty whether LLC members are "general" or "limited partners" for this test. Thus it is possible that, in some cases, LLCs taxed as partnerships must use the "accrual" method of accounting for income tax purposes if there are losses.

CANADIAN MAIL-ORDER BUSINESSES MAY UNKNOWINGLY SUBJECT US CUSTOMERS TO US SALES TAX

In a prior Taxletter we summarized some of the US rules for US State sales tax. Canadian businesses shipping goods into the US to US customers may generally be exempt from collecting State sales tax on the shipment if there is no other connection with the State (please see Exhibit 1 in the Summer, 2005, Taxletter).

However the US recipient of your shipment may have some liability for the tax. The rules vary by State. In Florida, for example, the State imposes a "use tax" of 6% on certain out-of-state purchases provided the item would have been taxable if purchased in Florida. This includes (among others) internet purchases, and other mail-order purchases, including computer equipment purchases ordered from out-of-state magazines.

In some States there is an exemption for items purchased in another State and used there for a specified time period. A sales tax credit may be available for sales tax paid in another State (but not for tax paid in Canada).

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EDITED BY RICHARD BRUNTON • 4710 N.W. 2ND AVENUE, SUITE 101 • BOCA RATON, FLORIDA 33341, U.S.A.
TEL (561) 241-9991 • FAX (561) 241-6332 • E-MAIL RB@TAXINTL.COM • WWW.TAXINTL.COM
ADDITIONAL FLORIDA OFFICE CONFERENCE FACILITIES IN NAPLES, SARASOTA AND TAMPA