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

US Supreme Court Refuses to Resolve Physical Presence Controversy

Readers are aware of the somewhat chaotic status of the rules for determining when an "out-of state" business (including a Canadian business) has "nexus" in an individual US State other than the State in which it is located, and is therefore subject to State Income or Franchise Tax in that other State.

The US Supreme Court previously decided there must be a "physical presence" in the other State for purposes of "nexus" for levying that other State's sales tax. However no such Decision has ever been issued by the US Supreme Court with respect to State Income or Franchise Tax.

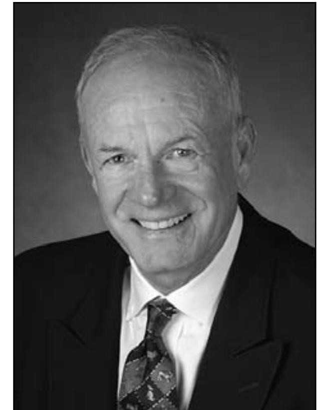
We previously mentioned that the US Supreme Court had been asked to decide whether the "physical presence" requirement also applies for State Income or Franchise Tax. However, on June 18, 2007, the US Supreme Court refused to hear the case.

New Federal Nexus Legislation Introduced

As a result of the Supreme Court's refusal to resolve the "physical presence" issue (above) additional legislation was introduced in the US Senate June 28th to require and define physical presence for State Income and Franchise tax purposes. (S. 1726).

No US Social Security for Green Card Holders?

New legislation introduced in the US House of Representatives on June 29th would deny non-US citizens any US Social Security credits earned after December 31, 2007, for purposes of computing their US Social Security benefits. (H.R. 190).



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 36 YEARS.

TAX-DEFERRED (1031) EXCHANGE NOW MORE HELPFUL FOR CANADIANS?

Provided the transaction is eligible, Section 1031 of the US tax code provides rules to allow you to defer payment of any US income tax (capital gains tax) you may owe on the sale of your US real estate if you exchange it for other US real estate. Generally you must exchange investment or business real estate for other investment or business real estate. In most cases (but perhaps not all) a residence that was used solely for personal purposes may not be eligible for this "1031 exchange" tax deferral. However the 1031 exchange may be helpful for rental or business property, and vacant land. Please see the Summer, 2005, issue of the Taxletter for some of the rules.

*ADDRESSES ONLY U.S. FEDERAL ISSUES -- STATE AND LOCAL ISSUES MAY ALSO APPLY.
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In the past this provision has not been helpful for many Canadians because Canada does not have a similar provision. Thus capital gains tax on the gain on the sale may still have been payable in Canada even though the US tax was deferred. Hence there was often no benefit to deferring the US tax. Perhaps worse, the Canadian and US tax would be payable in different tax years - maybe resulting in double tax since a "foreign tax credit" in Canada might not be available for the US tax when the "newly acquired" US property was ultimately sold.

However the following two recent developments, when taken together, may have changed the "calculations" and rendered the "1031 exchange" more practical now for Canadians selling US investment or business real estate:

1) The softening of the US real estate market in many areas, and

2) The decline in value of the US dollar against the Canadian dollar.

The Softening of the US Real Estate Market

After the rapid rise in real estate values in many parts of the US from 2000 to 2005, the value of many of those properties has remained stagnant or even declined in recent months. In some areas, such as Florida, some of the declines have even been dramatic. Thus the current sale of the real estate will naturally trigger much less tax than it would have earlier.

The Decline in Value of the US Dollar

In view of the recent sharp decline in the value of the US dollar against the Canadian dollar, many Canadians now selling US real estate will have a taxable gain for US tax purposes but a loss or substantially diminished gain for Canadian tax purposes. Therefore there may be US tax payable on the sale but little or no Canadian tax. In these situations a deferral of the US tax under the 1031 provision (if eligible) could be beneficial. The 1031 deferral could be beneficial not just because of the actual tax deferral, but also because of its impact on the so-called FIRPTA withholding. (see "***FIRPTA Withholding***" below).

FIRPTA Withholding

Readers are aware when US real estate is sold a US tax of 10% of the selling price is withheld at closing and sent to the IRS as a prepayment of whatever US income tax (capital gains tax) the seller owes. This is so-called "FIRPTA withholding" that is mandated by a separate provision in the tax law (Section 1445) to enforce compliance with "FIRPTA" - the "Foreign Investment in Real Property Tax Act". The "Foreign Investment in Real Property Tax Act" is US tax legislation that was enacted in 1980 to impose US tax on the sale of real estate by non-US persons. A "1031 exchange" constitutes a "sale" for purposes of "FIRPTA" and "FIRPTA withholding".

However exceptions to the FIRPTA withholding rule apply. (Please see the Fall, 2006, issue of the Taxletter). One exception provides that no FIRPTA withholding will be required if the transaction is a "nonrecognition" transaction, and other requirements are met. (Reg. 1.1445-3(c)(2)(ii)). Fortunately, a "1031 exchange *is* a "nonrecognition transaction", provided other requirements are met. (Reg. 1.1445-3(b)(6)).

Among the "other requirements", the seller must apply for a "withholding certificate" from the IRS. The withholding certificate application must include information substantiating that the requirements of section 1031 are satisfied. The IRS will normally take about 3-4 months to respond to the application.

If you apply for the withholding certificate sufficiently in advance, and receive the IRS response before the transaction (exchange) takes place, the exchange can proceed with no "FIRPTA withholding" (or whatever reduced amount is authorized by the IRS).

If you proceed with the sale (exchange) of your property before you receive the IRS response, the FIRPTA withholding rule applies. However the 10% tax can be held by the closing agent (and not remitted to the IRS) until the IRS response is received. Of course you, the seller, must temporarily lodge the 10% tax with the closing agent in this case. This will all be returned to you once the IRS response is received - subject to any IRS requirement that some of the tax be sent to the IRS. (See Reg. 1.1445-1(c)(2)).

US "ITINS" - IRS FORM W-7 - THE HAGUE CONVENTION - CORRECTION

The last issue of the Taxletter described procedures under which a nonresident alien can obtain a US individual taxpayer

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identification number (an "ITIN"). The article mentioned the ways in which a Canadian (or other non-US) passport can be certified to satisfy IRS requirements. One such way is certification by a home country Notary or Commissioner if it is certified in the format of an "Apostille", provided the Notary or Commissioner is licensed as such in a country that is a signatory to the "Hague Convention Abolishing the Requirement of Legalisation for Foreign Public Documents". This is Convention #12 of the "Hague Conference on Private International Law".

Approximately 97 countries have signed that particular Convention, including the United States, the United Kingdom, France, Germany, Italy, Spain, Switzerland Japan, India and Australia. In addition the Convention has been signed, for example, by Botswana, Honduras, Kazakhstan, Moldova, Romania, Serbia, and Suriname.

However, surprisingly, Canada has not signed that particular Convention and hence a passport certification executed by a private Notary or Commissioner in Canada that is not a US citizen is apparently not acceptable to the IRS. (However this is a complicated issue for the ITIN processing department of the IRS, and it would not be surprising if Canadian notarizations via Apostilles were, in fact, accepted).

US FOREIGN TAX CREDITS FOR US CITIZENS IN CANADA

Tax practitioners that assist individuals with Canada-US cross border tax matters are familiar with the foreign tax credit complexity that arises when a US citizen, resident in Canada receives "US source" income. Canada must give a credit (and/or deduction) for certain US taxes on US source income, and the US must give a credit or deduction for certain Canadian taxes on Canadian source income. Thus a circularity in computations exits.

Among other decisions the following must be determined:

1) The particular taxes involved, and whether they are eligible for credits,

2) The "source country" for the income earned, and

3) The sequence of the computations.

Source Rules

Each country has its own set of "source rules" under its domestic law. For example, interest and dividends are usually sourced in the country of residence of the payer. Compensation is usually sourced in the country where the work is performed.

However, the tax treaty has rules that override each country's domestic law - in this case the source rules. Thus, under the treaty rules, if a US citizen resident in Canada receives US bank interest or certain "portfolio interest" that is not connected with a US business, that interest is deemed to be sourced in Canada. Also, if a US citizen works temporarily in the United States (less than 183 days) for a Canadian employer that does not have a permanent establishment (PE) in the US, the compensation might be considered Canadian source income under the treaty. (See Treaty Article XXIV, paragraphs 3, 4, 5, and 6).

Sequence of the Computations

1) Citizen Tax. Although the foreign tax credit allowed on the Canadian income tax return is determined before the foreign tax credit allowed on the US income tax return, it is necessary first to compute what the US tax would be without allowing any foreign tax credit, and without considering the treaty's source rules or other rules of the treaty. This is sometimes referred to as the "citizen tax" since it would only apply to US citizens (or residents of the US). From this number a figure is computed for the US tax on US source income. Then, from that number, (US tax on US source income), you compute the US tax ("citizen tax") on each item of US source income - i.e. the tax on interest, the tax on dividends, the tax on rental income, employment income, etc.

2) Alien Tax. Second, you compute the US tax that would be payable on each item of US source income as if the taxpayer were a nonresident alien of the US. This is sometimes referred to as the "alien tax". Since this may result in a lower marginal tax rate on items such as rental income and employment income than the "citizen tax", this tax ("alien tax") may be lower than the "citizen tax").

3) Treaty Tax. Third, you compute the tax the US is allowed to collect on each item of income, under the treaty, from a nonresident

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alien of the US that is resident in Canada - for example, 15% on certain dividends and 15% on periodic pension payments.

4) Foreign Tax Credit Allowed in Canada. Fourth, you calculate the total amount of foreign tax credits allowed on the Canadian income tax return. This is calculated on an item by item basis - i.e. the tax credit is calculated separately for US interest, US dividends, US rental income etc. The tax credit allowed for each item of income is the lesser of:

a) the citizen tax,
b) the alien tax, or
c) the treaty tax,

on each item of income that was computed in 1, 2, and 3 above.

5) Foreign Tax Credit Allowed in the US (Regular). Fifth, you compute the "regular" US foreign tax credit on the US income tax return using the normal US foreign tax credit rules - i.e. calculating the Canadian tax on Canadian source income.

6) Foreign Tax Credit Allowed in the US (Additional). Sixth, you compute an additional foreign tax credit on the US return that is allowed under the treaty. This additional foreign tax credit is a tax credit that the US gives for Canadian tax on US source income! It is limited to the amount the Canadian tax on US source income exceeds the greater of:

a) the tax credit allowed by Canada on that income, or
b) the "treaty tax",

but cannot exceed the "citizen tax".

Also, please see the article ***"FOREIGN TAX CREDITS - CHANGES FOR 2007 & THE "HIGH TAX KICKOUT".***

CANADA VS. US APPROACH TO TAX TREATY "RESIDENCY"

In the United States the Internal Revenue Service takes the attitude that the provisions in a tax treaty are generally optional or elective on the part of the taxpayer as long as the treaty terms provide a less favorable result. Thus you are not "forced" to compute your tax under the treaty rules if that tax is higher. (Of course some treaty provisions, such as the exchange of information and tax collection activities, are at the option of the Governments!).

For example see Revenue Ruling 80-147 where the IRS held that:

1) Tax treaty provisions need not apply if their application resulted in greater tax than the tax liability arising under the tax code, and

2) The taxpayer may choose on an annual basis whether to be taxed under the US tax code or the tax treaty provisions.

Also, many US income tax treaties and the US Model Treaty (Article 1(2)) state that "the treaty shall not restrict in any manner any benefit" accorded by the (domestic) laws of the United States.

The US nonetheless takes the position that the taxpayer cannot "cherry pick" from the treaty within a given tax year - i.e. cannot choose to be taxed under the treaty for some types of income and taxed under domestic rules for other types of income.

As a result, the right of a US "resident alien" to exercise the Article IV provisions of the Canada-US treaty to be taxed as a non-resident of the US can apparently be elected at the option of the taxpayer. (Assuming of course, that the individual otherwise qualifies). In other words the application of Article IV to be taxed as a nonresident is not mandatory if it would result in greater tax than the tax that would apply if the individual were being taxed as a resident.

However Canada takes the opposite approach. Under Canadian Income Tax Act Section 250(5) an individual is deemed to be a nonresident of Canada if, under Article IV of the Canada-US tax treaty, the individual is considered to be a resident of the United States. Of course this would normally trigger Canada's departure tax rules even though the individual still qualifies as a resident of Canada under Canada's domestic rules for residency.

In some cases the immediate departure tax that would accrue to Canada may be much greater (and obviously more imminent) than the annual tax that would accrue to Canada if Canada continued to treat the individual as a Canadian resident. Hence, where the facts cooperate, there could be an incentive for Canada to treat the individual as a newly departed nonresident. (A caveat for some Canadians that become highly engaged in the United States).

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TAXATION OF CANADIAN NONRESIDENT ALIENS WORKING TEMPORARILY IN THE UNITED STATES

Canadian nonresident aliens of the United States that work temporarily in the United States (including individuals that meet the green card test or the substantial presence test but claim non-residence in the US under the tax treaty) may be exempt from US income tax under the tax treaty. However where the individual is ineligible for exemption under the tax treaty all the US rules will apply including those related to "fringe benefits" - i.e. other elements of the compensation package.

How are these fringe benefits taxed in the US? The benefits may include:

1) Moving expense re-imbursement,
2) Re-imbursement of US housing costs,
3) Other temporary US living expense such as meals and commuting to the worksite,
4) A company car, and
5) Various other re-imbursements for US tax, and "home leave" expenses.

Although the compensation itself is allocated (under the source rules) between the US and Canada based on the workdays spent in each country, the fringe benefits may be allocated entirely to the principal place of work, which could be the United States. (Reg. 1.861-4(b)(2)(ii)(D)).

CANADIAN BUSINESSES - IS YOUR US WORKER, AGENT, OR REPRESENTATIVE, AN "EMPLOYEE"?

Canadian businesses are aware if they have employees, certain "wage tax withholding" rules apply. But questions often arise over whether the individual is truly your "employee" or whether the individual is an "independent contractor", in which case there may be no withholding requirement.

Canadian businesses having workers, agents, or other representatives in the US - either full time or part time - are faced with a determination as to whether the individuals are "employees" or "independent contractors" according to the United States' rules for such determinations. Failure to make the correct determination can result in substantial penalties.

Except for Code Section 3508, (see "***Code Section 3508***" below), there is no precise US tax law defining an "employee". Normally the IRS uses a "facts and circumstances" evaluation to make a determination. (See "***Facts and Circumstances Evaluation***" below). As a result the IRS has developed a nonexclusive list of 20 factors that may assist in making a determination. These are set out in Revenue Ruling 87-41. (See "***The 20 Factors***" below). The relevant importance of each factor may vary depending on the individual's occupation and the facts involved.

A "safe harbor" rule also exists that may help in limited circumstances. (See "***Safe Harbor Rule***").

Code Section 3508

Internal Revenue Code Section 3508 provides that in the case of services provided "as a qualified real estate agent" or as a "direct seller", the individual will not be treated as an employee.

A "direct seller" means any person if:

(A) such person -

i) is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis which the Secretary prescribes by regulations, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment,

ii) is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment, *or*

iii) is engaged in the trade or business of the delivering or distribution of newspapers or shopping news (including any services directly related to such trade or business),

(B) substantially all the remuneration (whether or not paid in cash) for the performance of the services described in subparagraph (A) is directly related to sales or other output (including the performance of services) rather than to the number of hours worked, *and*

(C) the services performed by the person are performed pursuant to a written contract between such person and the person for whom the services are performed and such

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contract provides that the person will not be treated as an employee with respect to such services for Federal tax purposes.

Facts and Circumstances Evaluation

Under the "facts and circumstances" evaluation, Reg. 31.3401(c)-1(b) states "*Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee*"

The 20 Factors

The following is simply a list of the <u>headings</u> under which the IRS describes each of the 20 Factors. The next issue will include the full IRS description of each factor:

The <u>headings</u> are: Instructions, Training, Integration, Services Rendered Personally, Hiring, Supervision, and Paying Assistants, Continuing Relationship, Set Hours of Work, Full time Required, Doing Work in Employer's Premises, Order or Sequence Set, Oral or Written Reports, Payment by Hour, Week, or Month, Payment of Business and/or Traveling Expenses, Furnishing of Tools and Materials, Significant Investment, Realization of Profit or Loss, Working for More Than One Firm at a Time, Making Service Available to General Public, Right to Discharge, and Right to Terminate.

Safe Harbor

A "safe harbor" rule applies to exempt some employers from collecting "employment tax" (but not income tax). Generally this would occur if the employer relied on:

1) Past IRS practice with the employer,

2) Published rulings or judicial precedent,

3) Long-standing recognized practice in that particular industry, or

4) "Any other reasonable basis".

FOREIGN TAX CREDITS - CHANGES FOR 2007 & THE "HIGH TAX KICKOUT"

New US tax law changes, effective for tax years beginning in 2007, affect how US citizens and US residents (including green card holders living in Canada) allocate their non-US income and non-US tax for purposes of computing a foreign tax credit on the US income tax return.

Prior to 2007, when computing your foreign tax credit your non-US income and non-US tax were required to be allocated to one of <u>seven</u> different categories. Beginning in 2007 these have been reduced to only <u>two</u> categories, namely:

1) General category income, and

2) Passive category income.

Any foreign tax credit carryovers you have from prior years that were in <u>other</u> categories (for example the "high withholding tax interest" category) are placed instead in either the general category or passive category, depending upon how they would be classified if they arose under the new rules.

General Category Income

General category income means any income that is <u>not passive category income</u>. (IRC 904(d)(2)(A)(ii)).

Passive Category Income

Under Code Section 904(d)(2)(A)(i), "passive category income" means:

1) "<u>Passive income</u>", (see below), and

2) "<u>Specified passive category income</u>", (see Code Section 904(d)(2) (B)(v)).

"<u>Passive Income</u>". "Passive income" is generally income that would be "foreign personal holding company income" as defined in

Code Section 954(c). (See IRC 904(d)(2)(B)(i)). This includes certain interest, dividends, royalties, annuity income and certain gains and rents.

But passive income does not include:

1) "High taxed" income, and
2) Export financing interest.

(IRC 904(d)(2)B)(iii)).

High Taxed Income. "High taxed" income is transferred from the "Passive" category to the "General" category. This is often referred to as the "high tax kickout".

"High taxed" income is income that would otherwise be passive income but for the fact that the Canadian (or other non-US) tax with respect to that income is higher than "*the highest US tax that would be payable on that income*".

The "*highest US tax that would be payable on that income*" is computed by multiplying each type of income times the "highest US tax rate" applicable to that type of income.

The concept of "high taxed income", and the computation of whether you have it, can be very important because it can significantly affect the computation of your US income tax liability (beneficially or otherwise). There may be a substantial difference in your tax liability depending upon whether your non-US income is in the passive category or "kicked out" to the general category.

However, actually performing the calculation to determine if certain income is "high taxed" income (i.e. determining if the "high tax kickout" applies) can be problematic. For example the "highest US tax rate" depends upon whether the relevant income is ordinary income, qualified dividends, capital gain, etc., since each of these may have a different US tax rate.

Further, the Regulations require the foreign income to be grouped to make the calculation. (See Reg. 1.904-4(c)(2)(i) and Regs. 1.904-4T(c)(2), (3) and (4)). In addition, expenses related to a particular type of income must be grouped and netted against that income. (See Reg. 1.904-4(c)(2)(ii)). The "*highest US tax that would be payable on that income*" is thus determined by multiplying the net income in each group by the highest US tax rate applicable to that type of income.

Although Canada's maximum marginal tax rate for individuals exceeds the maximum marginal tax rate in the US, a determination of whether the "high tax kickout" applies will not necessarily always be simple for many individuals resident in Canada, even those in the highest Canadian tax bracket.

For example, individuals with short term capital gains, certain principal residence gains, or exemptions from the sale of businesses will have special calculations. Those with dividends from Canadian corporations may have special calculations in view of the Canadian dividend tax credit. Complexities may also arise on capital gain distributions from private Canadian corporations. Individuals selling Canadian corporate mutual funds have extremely complicated calculations due to the US "PFIC" ("Passive Foreign Investment Company") rules.

Individuals with large Canadian RRSP or pension contributions or other special factors or deductions that do not have a US counterpart may also have special computations because of the US requirement that income and related expenses be "grouped' for purposes of the "high tax kickout" computation.

Canada's rules permitting spouses to split pension income may also be a factor.

In many cases, especially for US citizens and green card holders living in Canada, it may be difficult to determine whether the "high tax kickout" applies. Nonetheless, there may be a substantial difference (beneficial or otherwise) in the US tax liability depending upon whether income is categorized as "passive" or "general".

NEW TAX FORM SCHEDULES FOR CANADIAN CORPORATIONS THAT FILE US TAX RETURNS

For Canadian corporations filing US federal corporate income tax returns (other than those claiming "no permanent establishment") there have long been "behind the scenes" computations required to correctly prepare the tax returns. Proposed new IRS tax forms for 2007 may highlight previously incorrect tax computations.

Unlike the Canada Revenue Agency, the IRS does not generally acknowledge the receipt of a tax return. The IRS does not immediately review a tax return it receives and issue a "Notice of Assessment". Hence there is often no assurance the IRS has even received your tax return, let alone agreed with it. Usually the IRS only communicates with you if:

1) There is an incorrect mathematical computation on the face of the return, or

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2) The IRS recorded a different amount of tax payment than you entered on your return.

If the IRS ultimately reviews your return and communicates with you, this could be many months or more likely years, after the original filing. If this leads to a question on prior returns, the Statute of Limitations may not protect you if the relevant tax return was incomplete or lacked full disclosure.

Hence the "behind the scenes" computations are important and proposed new tax forms for 2007 remove many of them from "behind the scenes" and place them directly on actual pages of the tax return.

Interest Expense

For example, a non-US corporation is required to stipulate (elect) its method of computing interest expense. Readers are aware the interest expense actually incurred in the United States by a non-US corporation is not necessarily the amount of interest the corporation is allowed to deduct on its US income tax return. The US tax code considers that debt or interest is a "fungible" commodity - transferable from country to country - and therefore the computation of the allowable interest deduction in the US is subject to rigorous rules to "protect" the US tax base.

Accordingly each non-US corporation must initially elect whether to use the "Adjusted US Booked Liabilities" method *or* the "Separate Currency Pools" method to compute its interest deduction on the US income tax return. Failure to do either in the past, would likely only have resulted ultimately in some uncertainty over the status of the corporation by the owners of the corporation and its tax preparer.

But for 2007 the IRS has added a proposed new "Schedule I" to the relevant corporate tax form (IRS tax Form 1120-F) that requires you to stipulate on the tax Form itself which interest deduction method you are choosing. (Please see Exhibit 1).

Further, having selected a method of calculating interest, you are then subject to a strict set of instructions on the Form (as set out in the Regulations) regarding the actual computations for the interest deduction based on the method you selected. In the past, disclosure of these computations was not required on the tax return, and therefore there was generally no IRS scrutiny of the calculations, (unless the tax return was audited). The new tax form, Schedule I, (2 pages long) requires you to show, step by step, how you computed the interest deduction. (Again please see Exhibit 1).

Other Expenses

When a Canadian corporation operates a branch of its business in the US, it is necessary to determine which Canadian and other worldwide expenses of the corporation are "effectively connected" with its US branch activities. These "effectively connected" expenses are then deductible on the US income tax return.

For example there may be overhead expenses in a Canadian head office that are related to the US branch activities. The US has complex rules to determine how such worldwide expenses are allocated and apportioned between "effectively connected" income and "non-effectively connected" income for US income tax purposes.

As in the case of interest expense, these computations were previously done "behind the scenes" on work papers not provided with the tax returns. Thus the computations were not subject to IRS scrutiny unless the IRS decided to audit that issue on that tax return.

However changes are apparently coming with the proposed new 2007 tax forms. You may be required to complete Schedule H (2 pages) showing exactly how you computed the amount you deducted for expenses on the US income tax return. (Please see Exhibit 2).

A CONNECTION BETWEEN CANADIAN PENSIONS & US ESTATE TAX!

If you are a Canadian that is a nonresident alien of the US you may wonder what possible connection there could be between your US estate tax exposure and your Canadian corporate pension. Unfortunately, there is a connection, and for some individuals the connection can have significant consequences.

Pension Payments That Continue to Your Surviving Spouse

If your Canadian corporate pension terminates at your date of death, there is

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EXHIBIT 1

SCHEDULE I (Form 1120-F)

Department of the Treasury
Internal Revenue Service

Interest Expense Allocation Under Regulations Section 1.882-5

▶ Attach to Form 1120-F.
▶ See separate instructions.

OMB No. 1545-0126

2007

Name of corporation | Employer identification number

A. Check here if the corporation is a foreign bank as defined in Regulations section 1.882-5T(c)(4) . . . . ▶ ☐

B. This Schedule I is being completed with respect to *(check one)*:

☐ Adjusted U.S. Booked Liabilities Method Under Reg. 1.882-5(d). **Complete lines 1 through 15 and 21 through 25.**

☐ Separate Currency Pools Method Under Reg. 1.882-5(e). **Complete lines 1 through 9 and 16a through 25.**

Step 1 Average U.S. Assets for the Tax Year: Regulations Section 1.882-5(b)

	(a) Set(s) of Books that Give Rise to U.S. Booked Liabilities (see inst.)	(b) Partnership Interests	(c) Set(s) of Books Other than those Described in Columns (a) and (b)	(d) Totals. Add columns (a) through (c)
1 Specify the method used to determine the value of the corporation's U.S. assets on lines 2 through 5 below *(check one)*: ☐ Adjusted Basis Method: Reg. 1.882-5(b)(2)(i) ☐ Fair Market Value Method: Reg. 1.882-5T(b)(2)(ii)				
2 Total assets per books				
3a Total interbranch assets				
b Total non-ECI assets under section 864(c)(4)(D) . .				
c Total other non-ECI assets				
d Adjustments for amounts from partnerships and certain disregarded entities included on line 2, column (a) . .				
e Adjustments for assets that give rise to direct interest expense allocations under Reg. 1.882-5(a)(1)(ii) . .				
f Other adjustments to average assets included in line 2 (e.g., mark-to-market differences)				
4 Combine lines 3a through 3f				
5 Total value of U.S. assets for the tax year . . . . **Column (a):** Subtract line 4 from line 2. **Column (b):** Enter total from Schedule P, line 19. **Column (c):** See instructions for amount to enter.				

Step 2 U.S.-Connected Liabilities for the Tax Year: Regulations Section 1.882-5(c)

6 Specify the method used to determine the amounts in Part II *(check one)*:

☐ Actual ratio under Reg. 1.882-5(c)(2). **Complete lines 6a through 6c below.**

☐ Fixed ratio under Reg. 1.882-5T(c)(4). **Complete line 6d below.**

a Average worldwide liabilities		
b Average worldwide assets		
c Divide line 6a by line 6b	%	
d Fixed ratio under Reg. 1.882-5T(c)(4). If the corporation is a foreign bank as defined in Reg. 1.882-5T(c)(4), enter 95% on line 6d. If the corporation is not a foreign bank, enter 50% on line 6d	%	
e Enter the ratio from line 6c or 6d, as applicable		%
7a U.S.-connected liabilities before Reg. 1.884-1(e)(3) election(s). Multiply line 5, column (d) by line 6e . .		
b Total amount of U.S. liability reduction under Reg. 1.884-1(e)(3) election(s)		
c **U.S.-Connected Liabilities.** Subtract line 7b from line 7a . . . . ▶		

Step 3 Interest Expense Paid or Accrued on Average U.S. Booked Liabilities: Regulations Section 1.882-5(d)

	(a) Set(s) of Books that Give Rise to U.S. Booked Liabilities (see inst.)	(b) Partnership Interests	(c) Totals. Add columns (a) and (b)
8 Total average amount of U.S. booked liabilities as defined in Reg. 1.882-5(d)(2) (see instructions)			
Column (a): Do not include amounts that give rise to directly allocable interest under Reg. 1.882-5(a)(1)(ii) or from partnerships includible in column (b). **Column (b):** Enter the total from Schedule P, line 17.			
9 Total interest paid or accrued during the tax year on line 8 amount			
Column (a): Do not include amounts that give rise to directly allocable interest under Reg. 1.882-5(a)(1)(ii) or from partnerships includible in column (b). **Column (b):** Enter the total from Schedule P, line 14c			

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Step 3 (cont.) Adjusted U.S. Booked Liabilities Method: Regulations Section 1.882-5(d)

If line 7 is greater than line 8, complete lines 10 through 13 below and skip lines 14a and 14b.
If line 7 is less than or equal to line 8, skip lines 10 through 13 and complete lines 14a and 14b.

10 If the corporation is a foreign bank which is making a current-year election to use the published average 30-day LIBOR (see instructions), check the box on this line, skip lines 10a through 10c, and enter the rate on line 10d . . . . ▶ ☐				
a Total interest paid or accrued during the tax year on U.S. dollar liabilities that are **not** U.S. booked liabilities included on line 8	10a			
b Average U.S. dollar denominated liabilities that are **not** U.S. booked liabilities included on line 8	10b			
c Divide line 10a by line 10b	10c	%		
d Enter the 30-day LIBOR rate, if elected under Reg. 1.882-5T(d)(5)(ii)(B) .	10d	%		
e Enter the rate from line 10c or, if elected, the 30-day LIBOR rate on line 10d			10e	%
11 **Excess U.S.-connected liabilities.** Subtract line 8 from line 7c . . . . ▶			11	
12 **Excess interest.** Multiply line 10e by line 11 . . . . ▶			12	
13 Add lines 9, column (c) and 12			13	
14a **Scaling ratio.** Divide line 7c by line 8, column (c)			14a	%
b Multiply line 9, column (c) by line 14a. See instructions for hedging amounts			14b	
15 **Interest expense allocable to ECI under the Adjusted U.S. Booked Liabilities Method.** Enter the result from line 13 or line 14b here and on line 21 . . . . ▶			15	

Step 3 (cont.) Separate Currency Pools Method: Regulations Section 1.882-5(e)

	(a) U.S. Dollar Denominated	(b) Home Country Currency. Specify: ▶	(c) Other Currency. Specify: ▶	(d) Other Currency. Specify: ▶
16a **U.S. assets.** Enter the corporation's U.S. assets, using the methodology in Reg. 1.882-5(e)(1)(i). If more columns are needed, attach schedule (see instructions) . . .				
b Check here if a less than 3% currency election was made . . . . ▶ ☐				
17a Enter the percentage from line 6e	%	%	%	%
b **U.S.-connected liabilities.** Multiply line 16a by line 17a, or, if a liability reduction election is made, see instructions .				
18a Enter the total interest expense paid or accrued for the tax year with respect to the foreign corporation's worldwide liabilities denominated in that foreign currency (enter in functional currency)				
b Enter the corporation's average worldwide liabilities (whether interest bearing or not) denominated in that foreign currency (enter in functional currency) . . .				%
c **Borrowing rate:** Divide line 18a by line 18b . . .	%	%	%	
19 **Interest expense allocation by separate currency pool.** Multiply line 17b by line 18c				

20 **Interest expense allocable to ECI under the Separate Currency Pools Method.** Total the amounts on line 19, columns (a) through (d), and amounts from attached schedule, if any, and enter the result here and on line 21 . . . .

SUMMARY—Interest Expense Allocation and Deduction under Regulations Section 1.882-5

21 Amount from line 15 or line 20, as applicable	21			
22 Enter the corporation's interest expense directly allocable under Reg. 1.882-5T(a)(1)(ii). (Include total from Schedule P, line 14b.) .	22			
23 **Interest expense allocable to ECI under Reg. 1.882-5.** Add lines 21 and 22 . . . . . ▶			23	
24a Amount of line 23 that is disallowed as a deduction under section 265 or under an income tax treaty (attach schedule—see instructions)	24a	( )		
b Deferred interest expense under section 163(e)(3), 163(j), or 267(a)(3) (attach schedule—see instructions)	24b			
c Amount of line 23 that is capitalized under section 263A (attach schedule—see instructions)	24c	( )		
d Combine lines 24a through 24c			24d	
25 **Total interest expense deduction under Reg. 1.882-5.** Combine lines 23 and 24d and enter here and on Form 1120F, Section II, line 18. The amount entered on line 25 may not exceed the total interest expense paid or accrued by the foreign corporation . . . . ▶			25	

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Schedule I (Form 1120-F) 2007

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EXHIBIT 2

SCHEDULE H (Form 1120-F)
Department of the Treasury
Internal Revenue Service

Deductions Allocated To Effectively Connected Income Under Regulations Section 1.861-8

► Attach to Form 1120-F.
► See separate instructions.

OMB No. 1545-0126
2007

Name of corporation | Employer identification number

Part I Deductions Directly Allocated and Apportioned to ECI and Non-ECI

Note. Enter all amounts in Part I in only U.S. dollars or in only functional currency. If U.S. dollars, check box ☐. Otherwise, specify currency ►

Line	Description		
1	Total expenses on the books of the home office	1	
2	Adjustments for U.S. tax principles (attach schedule - see instructions)	2	
3	Total adjusted deductions on the books of the home office. Combine lines 1 and 2		3
4	Interest expense (included in line 3)	4	
5	Bad debt expense (included in line 3)	5	
6	Total of interest expense and bad debt expense. Add lines 4 and 5		6
7	General and administrative deductions included in line 3. Subtract line 6 from line 3		7
8	Deductions directly allocable to non-effectively connected income from subsidiaries	8	
9	Deductions directly allocable to other non-effectively connected income booked in the home country	9	
10	Deductions directly allocable to other non-effectively connected income booked in other countries (including the United States)	10	
11	Add lines 8 through 10		11
12	Remaining deductions on the books of the home office allocable under Regulations section 1.861-8. Subtract line 11 from line 7		12
13	Less: Deductions directly allocated to effectively connected income		13
14	Remaining deductions on the books of the home office indirectly allocable under Regulations section 1.861-8. Subtract line 13 from line 12		14

Part II Home Office Deductions Indirectly Allocated and Apportioned to ECI and Non-ECI

Note. Enter the amounts in Part II, lines 16 through 21, in U.S. dollars.

Line	Description	
15	Average exchange rate used to convert allocable deductions to U.S. dollars (see instructions)	15
16	**Deductions indirectly allocable under Regulations section 1.861-8.** Enter the amount from line 14 in U.S. dollars. If line 14 is stated in functional currency, multiply line 14 by line 15	16
17	Indirect allocation and apportionment of line 16 amount to ECI (attach computation)	17
18	Deductions directly allocated to ECI from line 13, in U.S. dollars. If stated in foreign currency, multiply line 13 by line 15	18
19	Total home office deductions allocated to effectively connected income. Add lines 17 and 18	19
20	Total deductions from other non-U.S. locations allocated and apportioned to effectively connected income	20
21	**Total deductions allocated and apportioned to effectively connected income.** Add lines 19 and 20 and enter the amount here and on Form 1120F, section II, line 26	21

Part III Indirect Allocation and Apportionment Methods and Financial Records

Note. Enter the amounts in Part III, lines 22a, 22b, 23a, 23b, and 25 (if applicable), in U.S. dollars.

- If one or more methods used are different than in prior year, check box ☐
- If any amount on line 21 is recorded as an interbranch amount on books and records used to prepare Form 1120F, Schedule L, include on Part IV, line 36 and check box ☐

Line	Description		
22	Gross Income Ratio:		
a	Effectively connected gross income	22a	
b	Worldwide gross income	22b	
c	Divide line 22a by line 22b		22c %
23	Gross Asset Ratio:		
a	Average U.S. assets from Schedule I, line 5, column (d)	23a	
b	Worldwide assets (if applicable, from Schedule I, line 6b)	23b	
c	Divide line 23a by line 23b		23c %
24	Number of Personnel:		
a	Personnel of U.S. trade or business within the United States	24a	
b	Worldwide personnel of foreign corporation	24b	
c	Divide line 24a by line 24b		24c %
25	Other ratio based methods (attach schedule)		
26	Other methods (e.g., time spent analysis) (attach schedule)		

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Part III Indirect Allocation and Apportionment Methods and Financial Records *(continued)*

Financial and other records used to identify deductions allocated and apportioned to ECI

Line	Description	Yes	No
27a	Published or other non-public audited financial statements		
b	Non-audited financial statements		
28	Home office management or other departmental cost accounting reports		
29	Other (e.g., home country regulatory reports) (attach schedule)		

Part IV Allocation and Apportionment of Deductions on Books and Records Used to Prepare Form 1120F, Schedule L

Note. Enter all amounts in Part IV in U.S. dollars.

Line	Description		
30	Total expenses per books and records used to prepare Form 1120F, Schedule L		30
31	Adjustments for U.S. tax principles (attach schedule - see instructions)	31	
32	Total deductions per line 30 books and records. Combine lines 30 and 31	32	
33a	Third party interest expense per books and records	33a	
b	Interbranch interest expense per books and records	33b	
34	Bad debt expense per books and records	34	
35	Other third party deductions not allocable (attach schedule)	35	
36	Interbranch expenses per books not included on line 33b (attach schedule)	36	
37	Add lines 33a through 36		37
38	Deductions on books and records allocable and apportionable under Regulations section 1.861-8. Subtract line 37 from line 30		38

Reconciliation of allocable expenses on books under Reg. 1.861-8 (from line 38)		(a) ECI Amounts	(b) Non-ECI Amounts	(c) Total: Add columns (a) and (b)
39a Derivative transaction deductions directly allocated under section 1.861-8 (from line 38)	39a			
b Other deductions directly allocated and apportioned	39b			
40 Total expenses directly allocated and apportioned. Add lines 39a and 39b	40			
41 Deductions on books and records indirectly allocated and apportioned	41			
42 Total deductions allocated and apportioned. Add lines 40 and 41. Column (c) must equal line 38	42			

Note. Line 42, column (a) is the total of the deductions reported on Form 1120F, Section II, lines 12, 13, 14, 16, 17, 19, 20, 21, 22, 23, 24, 25, and 27.

Schedule H (Form 1120-F) 2007

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obviously no "value" to the pension thereafter. It is, effectively, "extinguished" and will have no US estate tax consequences.

However if the terms of the pension provide that all or a portion of the payments continue to your surviving spouse, (or other person), the pension does have some "value" at the date of death. If your surviving spouse is a US citizen and the pension payments continue to him/her, there will normally be no US estate tax significance to the continuing pension, due to the unlimited marital exemption on property passing to a US citizen surviving spouse.

But if your Canadian corporate pension continues to your non-US citizen surviving spouse there could be US estate tax significance to the value of your Canadian pension.

Significance of the Continuing Pension (Impact on Enhanced Unified Tax Credit)

Readers are aware the tax treaty between Canada and the US provides potential estate tax benefits to Canadians. Among other benefits, it allows Canadians a pro-rata portion of the estate tax "exclusion" that is available to US citizens and US domiciliaries. (The way the US domestic tax law is worded, the "exclusion" calculation is actually made on the basis of a "unified tax credit" against the estate tax, not on the basis of an "exclusion" from estate tax. Hence the treaty benefit available to Canadians is referred to as an "*enhanced unified tax credit*". The larger the "enhanced unified tax credit" the smaller the estate tax).

In order to obtain the "enhanced unified tax credit", the Canadian estate must disclose and value the Canadian property of the decedent, including the value of any pension described above.

The portion of the "enhanced unified tax credit" available to Canadians is based on the following fraction -

Value of the US Property Subject to Estate Tax
Value of the Worldwide Property

The larger the amount of worldwide property, the smaller the enhanced unified tax credit, and thus the larger the estate tax.

Canadian corporate pensions that continue are generally included in the computation of "worldwide property". So it is evident the Canadian pension can have an impact on the amount of the enhanced unified tax credit and hence the actual amount of US estate tax. Thus the "value" of the pension may be an important part of the US estate tax computation.

How is the Value of the Pension Computed?

The "value" of the pension is the "present value" of the "future stream of payments" to the surviving spouse. Thus, if the pension is paid for life to the surviving spouse the "value" of the pension is the "present value" of all the future payments the spouse will receive until he/she dies. Since it is unknown when he/she will die, it is necessary to determine his/her life expectancy and multiply this number by the annual pension amount payable to the surviving spouse. This total pension amount is then "discounted" based on a stipulated interest rate, to arrive at the "present" value of the total future pension payments.

Section 2039 of the tax code, Regulation 20.2031-7, and IRS Publication 1457 indicate these computations should be done in a prescribed sequence using IRS Tables. These steps are as follows:

1) Determine the surviving spouse's age closest to the decedent's date of death. (Reg. 20.2031-7(d)(1)).

2) Determine the appropriate interest rate for discounting (called the "Section 7520 interest rate") as at the date of death (or six months later - please see the article "***NONRESIDENT ALIENS- MORE SPECIAL COMPUTATIONS FOR US ESTATE TAX***").

Section 7520 rates change monthly. They can be found in IRS Revenue Rulings (which are included in the monthly IRS Bulletins) and in various tax research software.

There are several different classifications of Section 7520 interest rates. The "appropriate" one for estate tax pension valuations is "120 per cent of the mid term rate". This exact number is set out in the IRS Revenue Rulings.

3) Determine the "remainder factor" from Table S in IRS Regulations. (See Reg. 20.2031-7(d) and Reg. 20.2031-7(d)(2)(iv)(A) that lead you to Table S. Table S is located in Reg. 20.2031-7(d)(7) or IRS Pub 1457. (Table S contains figures for pensions that are payable annually at the end of each year. (Reg. 20.2031-7(d)(2)(iv)). So they must be adjusted - see step 6) below).

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4) Determine the "annuity actuarial factor" by subtracting the "remainder factor" from 1.000 and dividing the result by the Section 7520 rate determined in 2) above. (See Reg. 20.2031-7(2)(iv)(A)) and the example in Reg. 20.2031-7(2)(iv)(B)).

5) Determine the value of such a pension as if the pension were payable annually at the end of each year - (i.e. multiply the annual pension payment times the "annuity actuarial factor" determined in step 4) above (Reg. 20.2031-7(2)(iv)(A)).

6) The value of the pension determined in step 5) above is then modified if the payment is a monthly, or quarterly, payment, etc., rather the being paid annually at the end of each year. (See step 3) - Table S provides an annual figure).

End of Month Payment. If it is a monthly, or quarterly payment, etc., made at the end of the month, or quarter, etc., the pension amount determined in step 5) is multiplied by an adjustment factor obtained from Table K. (Reg. 20.2031-7(2)(iv)(B)). Table K can be found in Reg. 20.2031-7(d)(6) or IRS Pub 1457.

Beginning of Month Payment. If it is a monthly, or quarterly, etc. payment made at the beginning of the month, or quarter, the value of the pension is the sum of:

a) the value determined from this step 6) above "as if" the payment were made at the end of the monthly, quarterly ,etc., period, whatever the case may be plus:

b) the first month's pension payment. (Reg. 20.2031-7(d)(2)(iv)(C)).

THE CANADA-US TOTALIZATION AGREEMENT

Among other treaties, Canada and the US have entered into both a tax treaty and a social security treaty (referred to as the "Social Security Totalization Agreement").

The "totalization" agreement, along with an additional understanding between the US and Quebec, covers Canadian and US social security taxes and benefits.

The totalization agreement is intended to:

1) Help people who would otherwise have to pay social security taxes to both countries on the same earnings (for example an individual who is resident in one country but goes to work temporarily in the other country), and

2) Help many people who, without the agreement, would not be eligible for monthly retirement, disability or survivor's benefits under the social security systems of one or both countries.

For Canada, the agreement (and understanding with Quebec) apply to the Old Age Security Program, the Canada Pension Plan ("CPP") and the Quebec Pension Plan ("QPP").

For the US, the agreement applies to social security taxes, (including the Medicare portion of taxes), and retirement, disability and survivors insurance benefits. The agreement does not cover benefits under the US Medicare Program. Please see US Medicare Benefits under the heading "***Using the Agreement for US Benefits***", below.

In prior Taxletters we summarized how the agreement helps employees and self-employed individuals avoid being subject to social security taxes in both countries, and we will repeat this in the next Taxletter.

The comments below summarize some of the rules with respect how the agreement helps some individuals to use work credits in one country to obtain benefits in the other country.

Using the Agreement for US Benefits

If you do not have enough work credits under the US system to qualify for regular US benefits, you can potentially use both US and CPP/QPP benefits to qualify for partial US social security payments. However to be eligible to have the Canadian credits counted you must have earned at least six credits (generally one and one-half years of work) under the US system. (If you already have enough credits under the US system to qualify for a benefit you cannot count the Canadian credits).

When you apply for such a benefit in the US with respect to your Canadian credits, the US Social Security Administration will automatically obtain a copy of your records directly from Canada.

When a US benefit becomes payable as a result of counting both US and Canadian credits, an initial benefit is determined based on your US earnings, as if your entire career had been completed under the US system. This initial benefit is then reduced to reflect the fact that Canadian credits helped to make the benefits payable. The amount of the reduction depends on the amount of US credits you have. (Larger credits mean a smaller reduction).

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If you qualify for US social security benefits using a CPP/QPP benefit from Canada you will be subject to the "*Windfall Elimination Provision*" ("WEP') that was mentioned in a prior Taxletter. (Receipt of Canadian Old Age Security Pension does not trigger the WEP because it is based on Canadian residency, not on earnings). The WEP is a provision in the US domestic law (not the totalization agreement) that can affect the amount of the US Social Security payment you receive if you also receive a pension based on work that was not covered by US social security. For a brief comment on the WEP please see ***Windfall Elimination Provision*** below.

US Medicare Benefits. - Medicare is the US national health insurance system for individuals 65 and over, or who are disabled. Medicare has two parts: "Part A" (Hospital Insurance), and "Part B" (Medical Insurance). You are eligible for free Hospital Insurance at age 65 if you have worked long enough under US social security to qualify for a retirement benefit. Individuals born after 1928 need 40 credits (about 10 years of covered work) to qualify for a retirement benefit.

Work credits from Canada cannot be used to qualify for Part A, Hospital Insurance. However certain individuals that have been resident in the US for a prescribed time period are eligible to purchase Hospital Insurance from the US Social Security Administration.

Receipt of US Social Security Payments Outside the United States

If you are a US or Canadian citizen living outside the US you will continue to receive your US social security payments as long as you are otherwise eligible for them. (Certain restrictions apply to payments to Cuba, North Korea, Cambodia, Vietnam and selected countries of the former Soviet Union).

Windfall Elimination Provision ("WEP")

If you work for an employer that does not withhold US Social Security taxes (such as a government agency or Canadian employer) the pension you receive based on that work may reduce your US Social Security benefits. This "Windfall Elimination Provision" ("WEP") affects how your US Social Security and retirement benefits are calculated. The WEP is only triggered by pension benefits based on salary. Thus your OAS benefits, which are based on residence not salary, do not reduce your US Social Security benefits.

There are exceptions to the WEP general rules. The WEP does not apply to survivor's benefits. It also does not apply if:

1) You have 30 or more years of "substantial earnings" under US Social Security, or
2) You are a US federal worker first hired after December 31,1983, or
3) In certain cases where you were employed on December 31, 1983, by a nonprofit organization, or
4) Your only pension is based on certain railroad employment, or
5) The only work you did where you did not pay US Social Security was before 1957.

Please refer also to the Fall, 2002, issue of the Taxletter.

Using the Agreement for Canadian Benefits

Old Age Security Program. Under the agreement, Canada will consider your US Social Security credits earned after 1951 and after age 18, along with periods of residence in Canada, to meet the OAS residence requirements. However to have the US credits counted you must have resided in Canada for at least one year after 1951 and after age 18.

Canada/Quebec Pension Plan (CPP/QPP).

1) It is not necessary to consider US Social Security credits to determine eligibility for CPP/QPP retirement benefits since anyone who has made at least one contribution to either plan can qualify for retirement benefits.
2) However US Social Security credits completed after 1965 may be considered along with CPP/QPP credits to meet the minimum requirements for CPP/QPP disability or survivor benefits.

CANADIAN & US TRUST RULES CONFLICT FOR CANADIAN DISTRIBUTIONS TO US RESIDENTS

US residents receiving distributions from a Canadian trust or estate may be faced with a US tax reporting difficulty stemming from a difference in Canadian and US rules, and an information gap that may result.

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Canadian Rules

When a Canadian trust (or estate) makes a distribution of its income to a nonresident of Canada the trust generally must withhold at source and remit to the Canada Revenue Agency ("CRA") 25% of the distribution. (ITA 211(1)(c)(i)). However if the recipient is a US resident, the tax rate is reduced to 15% pursuant to Article XXII of the treaty. (The distribution will only be taxable under 211(1)(c)(i) to the extent the amounts would have been taxable under Part 1 of the ITA if the beneficiary were resident in Canada).

The "character" of the income (i.e. whether it is interest, dividends, capital gains, etc.) that has been earned by the trust (or estate) and is being distributed to the beneficiary is not taken into consideration. (ITA 212(11) and IT- 465R, paragraph 6).An exception applies if the trust is a mutual fund distributing capital gain. (ITA 212(1)(c)(i), ITA 104(13), ITA 104(21), and IT- 465R, paragraph 3).

Because the "character" is irrelevant for Canadian purposes, the trust or estate generally must withhold 15% of payments to US residents regardless of whether the amount distributed represents a payment of amounts earned by the trust or estate that would normally be nontaxable to nonresidents of Canada such as certain securities gains, and interest on Canadian Government debt. Further, no distinction is required to be made on the tax reporting slip issued by the trust or estate. Unlike Form T3 issued to Canadian residents that stipulates the type ("character") of income being distributed, CRA Form NR4 issued to nonresidents aggregates all the distribution into one figure labeling it Code 11 ("Estate and Trust Income").

US Rules

Except for so-called "accumulation" distributions, - i.e. distributions of income earned by the trust in a prior year, - a distribution from a Canadian trust or estate retains its "character" for purposes of the US income taxation of the US recipient. (IRC 652(b)).

Therefore if the trust is distributing its earnings of interest, dividends, and/or capital gains, a pro-rata portion of the distribution is taxed to the US resident "as if" it is interest, dividends, and/or capital gains. The distinction can be important to the US recipient because of the difference in US tax rates applicable to interest, dividends, capital gains, etc.

However since this allocation of income is not stipulated on Form NR4, the US recipient will often have no way of knowing how to correctly allocate the payment to the type of income it relates. Therefore when Canadian trustees or executors are making distributions to US beneficiary/recipients it may be helpful if they provide a separate letter to the beneficiary setting out the "character" of the income being distributed. Also, in the case of a Canadian estate with a fiscal year, it may help to clarify, in writing, the exact date when the actual distribution occurred.

MORE "PHISHING" & ALSO "THE TAX GAP"

By Robert S. Blumenfeld, Esq.
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One of the latest scams was so widespread, the Internal Revenue Service actually issued a bulletin about it. An entity sent e-mails to "victims" indicating that the IRS had joined with 17 tax preparation software companies to assist taxpayers in filing tax returns quickly to expedite "special" refunds. To obtain assistance from this entity, the e-mail simply required you to submit your social security number and bank account information so that the IRS and its "allies" could speed the refund into your bank account.

At last count some 170,000 taxpayers had been contacted by such "phishermen". You can review some of these scams by going to the IRS website - www.irs.gov, and clicking on "Warning on Scam Emails" near the top center.

As a separate matter, both US political parties express a desire to shrink the claimed $290 billion difference between taxes owed, and the amount that is actually collected, (the "tax gap"). Perhaps one way to accomplish this is for Congress to fund substantial increases in the number of IRS agents to audit tax returns. Presently the IRS examines less than one out of every 100 returns, and many of these examinations are simply letters informing a taxpayer that his/her tax return failed to report income of which the IRS was advised via a tax slip.

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The fear of examination used to compel substantial compliance by taxpayers. However the decrease in audits has so diluted this fear that more people are now willing to "gamble".

A reduction in the "tax gap" might result if the "paper trail" (via "tax slips") were increased. Suppose the Congress (or the IRS if it possessed the authority) required each taxpayer to report to the IRS everyone to whom he/she made a payment - the gardener, the babysitter, the roofer, etc? Of course this frightening thought is not practical (at least in the short to medium term). Apart from the difficulty in educating payer-taxpayers, it would result in an avalanche of paperwork that would surely overwhelm the Internal Revenue Service. It remains to be seen what measures Congress will implement in the next couple of years to try to decrease this "tax gap".

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NONRESIDENT ALIENS - MORE SPECIAL COMPUTATIONS FOR US ESTATE TAX

The article ***"TAX-DEFERRED (1031) EXCHANGE NOW MORE HELPFUL FOR CANADIANS?"*** mentioned one of the consequences of recently declining real estate values in some parts of the United States. Another consequence, of course, is reduced exposure to US estate tax for the estates of those that recently died while owning such property.

In cases where real estate values have declined, there may be a potential additional benefit for the estates of recently deceased Canadians that should not be overlooked.

Canadians are generally subject to US estate tax on the value of their US property at the date of death. However, each estate is entitled instead to elect to pay tax on the value of the US property at a date six months after the date of death (or the date it is sold, if earlier) - the "six months" election.

If a Canadian passed away on, say, November 15, 2006, and the US real estate owned by the decedent declined significantly in value by May 15, 2007, it might be beneficial to make the "six months" election to value the property at May 15, 2007, instead of November 15, 2006, and pay estate tax on the May 15, 2007, value.

If the Estate is not making any claim under the "unified tax credit" provisions of the tax treaty, the benefit of this election may be as simple as it appears. However if the Estate *is* making such a claim, there are two factors that could reduce (but maybe not eliminate) the usefulness of such an election, namely:

1) The Unified Tax Credit Calculation, and

2) The Canadian/US dollar Exchange Rate.

Unified Tax Credit Calculation

Nonresident aliens of the United States that are residents of Canada are entitled to claim an "enhanced unified tax credit" under the tax treaty to reduce their US estate tax.

On the US estate tax return, the first step is to compute the "tentative" US estate tax on the value of the US property. Then, under the treaty, this "tentative" tax is reduced by the amount of the "enhanced unified tax credit" claimed under the treaty. The larger the "enhanced unified tax credit", the smaller the estate tax.

However to obtain the "enhanced unified tax credit" the Estate must disclose and value the worldwide property of the decedent. (Please see ***"Significance of the Continuing Pension"*** in the article ***"US ESTATE TAX & CANADIAN PENSIONS - WHAT IS THE CONNECTION?"***).

The amount of the "enhanced unified tax credit" is determined by the ratio -

$$\frac{\text{Value of the US Property Subject to Estate Tax}}{\text{Value of the Worldwide Property}}$$

The larger the ratio, the larger the "enhanced unified tax credit".

If the numerator of the fraction is reduced due to a decline in the value of the US property, the ratio is also reduced, but fortunately not proportionately (assuming the value of the non-US property remains the same). Accordingly there may normally still be some benefit to making the "six months" election.

If the estate chooses to make the "six months" election, and the "enhanced unified tax credit" claim under the treaty, it must also value all the non-US assets six months later - not just the US property. The denominator in the above fraction could therefore increase if

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the non-US property increased in value after the death. Since increasing the denominator reduces the amount of the "enhanced unified tax credit" this could reduce the benefit of the "six months" election.

Canadian/US dollar Exchange Rate

For purposes of the fraction set out above, the denominator (worldwide property) must of course be valued in US dollars. Because the Canadian dollar has significantly appreciated against the US dollar in recent months the Canadian property, valued in US dollars, may now be worth significantly more even if it remains the same value in Canadian dollars. This increases the value of the denominator (reduces the ratio) and thus potentially reduces the "enhanced unified tax credit" and the benefits of the "six months" election.

Nonetheless, in view of the status of many US real estate markets, there could still be significant US estate tax savings by making the "six months" election. It may be helpful to make test computations at both the date of death and six months later.

US CITIZENS WITH PRIVATE CANADIAN CORPORATIONS

In addition to other US reporting requirements previously mentioned, (e.g. IRS Forms 5471 and 3520), US citizens and US residents (including green card holders living in Canada), must generally report their transfer of property to their private Canadian corporations or partnerships. (See IRS Form 926 and Code Section 6038B for rules and exceptions).

The penalty for failure to report is 10% of the value of the property transferred and you will potentially have a taxable gain on the appreciation in the property. (See IRC 6038B(c) and IRC 367).

10% Penalty

For example, if you personally own Canadian real estate (or securities) with a cost base of $100,000 and you transfer it/them to your private Canadian corporation (or partnership) at a time when the fair market value of the property is, say, $300,000 there could be a penalty of $30,000 if you fail to timely file IRS Form 926.

A special exception applies to the transfer of cash. Apparently contributions to capital, or loans to the corporation, are not covered by Code Section 6038B (but may be covered by other Code Sections). However if the transfer of cash is related to certain types of corporate reorganizations, Form 926 may be required. (Please see Reg. 1.6038B-1(b)(3)).

Potential Taxable Gain

As a general rule under Code Section 367, when you transfer appreciated property (e.g. real estate or securities) to a Canadian or other non-US private corporation there is a taxable gain triggered in the US, based on the difference between the fair market value of the property and your cost base.

Thus in the example presented, there could be US tax triggered on a gain of $200,000. However the rules are complex and many exceptions apply. For example, the transfer of real estate that is involved with an active business is potentially exempt from the gain recognition (but not the Form 926 reporting).

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