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

Hard Copy of Publication was Exempt, but Electronic Version was Taxable

New York decided the hard copy version of a publication that provided news, etc., was exempt from NY sales tax but the electronic version was taxable. (TSB-A-07(6)S, NY Comm. of Taxation and Finance, Mar 16, 2007).

Virginia Distribution Center did not Constitute Nexus

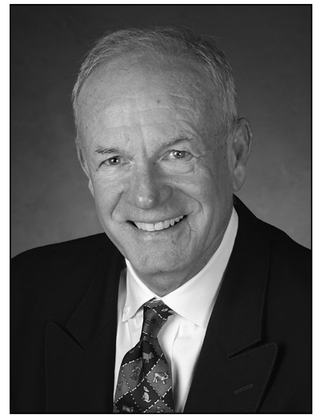
An out-of-State taxpayer's use of a Virginia distribution center would not create nexus if the distribution center purchased products at the taxpayer's request from unrelated vendors and retained title until delivery to a common carrier. (Ruling of Commissioner, P.D. 07-24, Virginia Department of Taxation, Mar 27, 2007).

Franchise Tax Calculation Requires Foreign Income

In determining the allocations for NY State franchise tax, (not income tax) a firm headquartered in India was required to include foreign source income in the computation of entire net income. (Infosys, NY Div. of Tax Appeals, Administrative Law Judge Unit, DTA No. 820669, Feb 15, 2007).

Telecommuters Create Texas Nexus

An out-of-State taxpayer was deemed to have nexus in Texas for Texas sales tax purposes because of having two employees in Texas working from their homes. (Letter No. 200611818L, Texas Comptroller of Public Accounts, Nov 16, 2006).



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.

Sales Tax on Out-of-State Vendor of Service Contracts

An out-of-State company that sells extended service contracts to New York customers through direct mail solicitations and provides the customers with repair services through designated repair centers in New York was determined to have nexus in New York for sales tax purposes. (TSB-A-06(29), New York Comm. of Taxation and Finance, Nov 30, 2006).

No Double Income Tax on Telecommuters?

Both US Houses of Congress have introduced legislation to limit individual State's ability to levy personal income tax on telecommuters. (H.R. 1360 and S. 785). An employee would have to be working <u>within</u> a State for the State to collect personal income tax.

Sales Tax not Applicable to Electronically Delivered Videos

New York has determined that the sale of videos delivered electronically over the

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internet to customers' computers is not subject to sales tax. (TSB-A-07(11)S, New York Comm. of Taxation and Finance, Apr 12, 2007).

BEWARE STATE SALES TAX ON YOUR US RENTAL INCOME

If you own rental property located in the United States you may be subject to State sales tax on the rental income. Each State has its own set of tax rules so you must evaluate your requirements on a State-by-State basis.

In addition, some individual counties levy their own sales tax under a different name. For example some Florida counties levy a "Tourist Development" tax on short term residential rentals. So you must check these requirements on a County-by-County basis.

Somewhat problematic is the fact that under federal income tax law, certain expenses of the landlord paid by a tenant are considered to be additional rental income for the landlord. Thus if your tenant pays the property taxes or insurance on your property (common in commercial rental real estate) the amount paid by the tenant is considered rental income to you. Of course in this case you can then also deduct the amount as an expense.

However the State in which the property is located may also consider the amounts paid by the tenant as rental income, which means State sales tax is payable on the taxes and insurance (and perhaps other expenses) paid by the tenant. The rules vary so you must evaluate your obligations on a State-by-State basis.

ARE GREEN HOLDERS SUBJECT TO US ESTATE TAX ON EVERYTHING?

In addition to US citizens, individuals that are domiciled in the United States are also potentially subject to US estate tax on their worldwide assets and also potentially subject to US gift tax on their worldwide gifts. (Please see **"*Gifts*"** below.)

When is a green card holder (or other individual) considered to be "domiciled" in the United States?

We previously mentioned the definition of "domicile" for US estate and gift tax is different than the definition of "resident for income tax". Unlike residency for income tax, "domicile" is not defined in the tax code.

"*In fact, it seems that such a definition is impossible. Every case possesses peculiarities different from any another case, and the issue must be decided in the light of the facts peculiar to each case*". (Bank of New York and Trust Co. v. Commissioner, 21 B.T.A. 1197, 203 (1930)).

Under ordinary circumstances, the place of birth is the first domicile. "*A domicile acquired is presumed to continue until it is shown to have been changed*". (Estate of Nienhuys v. Commissioner, 17 T.C. 1149, 1159 (1952)).

"*If there is doubt, the presumption is that the domicile has not changed*". (Weiss v. Commissioner 30 B.T.A. 478, 487 (1934)).

The US tax regulations attempt to provide guidance by stating "*a person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal*". (Reg. 20.0-1(b)(1)).

Thus, to establish a new domicile in the US, two things are indispensable.

1) The individual must have lived in the US, and

2) He/she must intend to remain indefinitely.

Both elements must be present to establish a new domicile. (Mitchell v. US, 88 U.S. (21 Wall) 350, 353 (1874), etc. above).

Therefore, although a green card is a US immigration document, it is not necessarily evidence the holder is domiciled in the United States. As indicated above, apart from living in the US, the holder must intend to remain indefinitely in the US.

Every individual who acquires a green card may not have a present intention of remaining indefinitely in the United States. For example, in cross border second marriages involving widows and widowers of Canada and the US, the Canadian spouse may acquire a green card solely as a matter of convenience. The couple may spend six months annually in each country and the Canadian spouse may have no intention of giving up Canadian domicile.

In other examples, Canadians many obtain green cards via lotteries or family members but defer actually moving to the United States. Or a Canadian may have lived in the US with a green card but later moved back to Canada and retained the green card. Although perhaps not in compliance with the purpose for which a green card is issued, it is a fact that many Canadians with green cards live full time in Canada.

In one important case involving the domicile of an individual that possessed a green card, the issue was decided on the basis of the decedent's intent, not the fact he possessed a green card. (Estate of Kahn v. Commissioner, 75 T.C.M. 1997).

Although having a green card enables an individual to have the intent to live in the US, many individuals without green cards also have the present intention of remaining indefinitely in the US.

Gifts

Because of the interaction of the tax treaty and the phased-in changes to the US estate tax rules, many Canadians will be free of a US estate tax liability. Hence the possession of a green card and the issue of domicile may not be of practical concern to them for purposes of estate tax.

However the US gift tax rules are very different. The tax treaty does not provide gift tax benefits and the US domestic law is more restrictive on gifts. Thus the issue of domicile may be much more important to many Canadians for gift tax purposes than for estate tax.

A Canadian domiciled in the US that transfers (gives) any assets (even assets in Canada) may be subject to US gift tax. This could even apply when transferring property to a spouse if the transferee spouse is not a US citizen.

US CITIZENS AND US RESIDENTS - "FOOD FOR THOUGHT" IF YOU OWN A CANADIAN MUTUAL FUND

We previously mentioned the unfortunate US tax consequences that may result if you own a Canadian (or other non-US) mutual fund that is organized as a corporation. (If the mutual fund is instead organized as a trust there are other important US compliance issues. Please see page 5 of the Fall, 2006, issue of the Taxletter).

A Canadian or other non-US mutual fund that is organized as a corporation is likely a "passive foreign investment company" (PFIC) according to US tax rules. Please see the separate article ***"PASSIVE FOREIGN INVESTMENT COMPANIES (PFICs)"*** for a description of the potentially very negative US income tax consequences to you if you own a Canadian mutual fund that is a PFIC.

As set out in that article there are two ways to ameliorate the negative US tax consequences, namely:

1) The QEF election, and

2) The "mark to market" election.

The QEF election may be impractical for many individuals because information you require on an annual basis may not be available.

However the mark to market election generally only requires knowledge of the year end closing price of the mutual fund's shares. You simply elect to pay tax in the current year (at ordinary rates) on the mutual fund's increase in share value. Although this may accelerate your tax liability to the current year, rather than deferring it to the year of sale, it may be an advisable course of action because it:

1) Limits the tax rate to your marginal tax rate for the current year, rather than taxing you at the maximum tax rate,

2) Avoids an IRS charge to you of potentially many years of compound interest on the tax liability, and

3) Allows you to deduct currently any decline in value of your shares.

Also, there is a exceptional benefit for non-US citizens that first become US residents that should not be overlooked, and that greatly increases the attractiveness of making the mark to market election. Such individuals can obtain a "step up in cost basis" in such shares to the fair market value at the beginning of the year in which they become US residents. (IRC 1296(l)). Please see the article ***"PASSIVE FOREIGN INVESTMENT COMPANIES (PFICs)"***.

DOES YOUR CANADIAN BUSINESS HAVE A US FEDERAL INCOME TAX LIABILITY?

If you are engaged in a trade or business in the US you must file a US federal income tax return. However if, after genuine analysis, it is doubtful but uncertain whether you are engaged in US business you can file a very simple "protective" US income tax return showing zero tax liability on business income. This will normally commence the 3 year period of limitations with the IRS.

However, if you determine that you are engaged in US business, but you do not have a "permanent establishment" (PE) in the US, there may be no US federal income tax liability but you must nonetheless file a US income tax return to make the relevant tax treaty claim.

ARE YOU ENGAGED IN A US TRADE OR BUSINESS?

What constitutes "being engaged in a trade or business in the US"?

The performance of personal services in the US by a nonresident alien constitutes "being engaged in a US trade or business". (IRC 864(b)(1)).

Apart from that, the rules are unclear. The courts have held that the US activity must be "considerable, continuous and regular". (Pinchot, 113 F2nd, 719).

Thus, engaging in a single transaction, (Pasquel, 12 TCM 1431), or engaging only in bookkeeping or ministerial activities in the US (Scottish American Investment Co. Ltd., 12 T.C. 49), would not normally constitute being engaged in a US trade or business.

Apparently it is not necessary to have a fixed place of business in the US to be considered "engaged in US business".

Not just your own activities, but also the activities performed by others (e.g. activities performed by agents) may be taken into account in determining whether you are engaged in US business. Whether the activities of an agent are attributed to you will depend on the facts and circumstances, and whether it is a dependent or independent agent.

Dependent Agents

The activities of a dependent agent will be attributed to the principal if the agent works exclusively for the principal. (Rev Rul 70-424). But see PLR 9229025 where a subsidiary engaged in US business is not necessarily an agent.

"Agency" relationship generally involves:

1) The power of the agent to bind the principal as to third persons;

2) The existence of a fiduciary relationship between principal and agent; and

3) The right of the principal to control the conduct of the agent with respect to matters entrusted to him.

(Mills, 132 F 2d. 753; European, 11 T.C. 127).

Independent Agents

An "independent agent" is one who "holds himself out" as doing business on his own account, under his own name, and who is willing to act on behalf of more than one principal.

An "independent agent" means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity. (Reg. 1.864-7(d)(3)(i)).

Whether the activities of an independent agent will be attributed to the principal apparently depends on the circumstances. An independent agent that acts almost exclusively for its principal may cause its activities to be attributed to its principal. (See Reg. 1.864-7(d)(3)(iii), and Rev Rul 70-424).

However, extensive activities performed on your behalf by an independent agent (even if not exclusive) may result in attribution to you. (For example, see Rev Rul 55-617).

The determination of whether an agent is independent may be made without regard to whether there is common ownership. (Reg. 1.864-7(d)(3)(ii)).

IF YOU ARE ENGAGED IN US BUSINESS WITH A "PE", WHAT IS TAXED?

If your Canadian business does not have a "permanent establishment" (PE) in the US, the Canadian business may not have a US federal tax liability. We previously summarized some of the rules for determining whether you have a PE in the US. A PE is not necessarily limited to "bricks and mortar". A US agent, or an executive of the business working temporarily in the US, may constitute a PE.

But if you do have a PE in the US, what is taxed? In this case, all of your income that is considered "effectively connected" with your US business will be subject to US tax. But beware the extent of the definition of "*effectively connected*". It could include:

1) All your US source income, and

2) All your non-US source income attributable to your US fixed place of business.

And beware, the US fixed place of business of <u>your agent</u> may be attributed to you for purposes of 2) above.

1) All US source Income

If you are engaged in a US business during the year, <u>all</u> of your <u>US source income</u> (other than certain clearly unconnected interest, dividends, gains, rents, etc) <u>will be considered effectively connected</u> with your US business. (Reg. 1.864-4-(a)).

Thus if you carry on two distinctly different businesses in the US, and only one has a PE, <u>the other business may be tainted</u> and subject to US income tax despite the absence of a PE in that business.

2) All Foreign Source Income Attributable to a US Fixed Place of Business

Incredibly, if you are engaged in business in the US, certain <u>foreign source income</u> (e.g. Canadian source) will be considered <u>effectively connected</u> with the US business (and thus subject to tax in the US) <u>if you have</u> <u>a "*US office or other fixed place of business*</u> *that actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and buyer*". (<u>Reg. 1.864-6(b)(2)(iii)</u>).

The tax regulations discuss the following issues in the determination of what constitutes a US office or other fixed place of business: *Fixed Facilities, Management Activity, Employee Activity, Office or Other Fixed Place of Business of <u>Related Parties</u>, and <u>Agent Activity</u>* (<u>See Reg. 1.864-7(b)</u>).

Your concern is not just whether <u>your own business</u> has a "US office or other fixed place of business". The office or other fixed place of business of your <u>agent</u> can <u>be attributed to you!</u>

Thus there is a danger the profits of your <u>non-US business</u> conducted outside the US, will be <u>taxed in the US</u> if it is somehow connected to a US fixed place of business of a US agent you may have. (Please see InverWorld v. Commissioner 71 T.C.M. 3231).

Attribution of an Agent's US office or Other Fixed Place of Business

For purposes of the taxation of "foreign source income" (mentioned above), under what circumstances will you be <u>deemed</u> to have a US office or fixed place of business due to the <u>activity of an agent</u> that <u>has</u> an office or fixed place of business?

<u>Dependent Agents</u> - An office or fixed place of business of a dependent agent can be attributed to you if the agent:

1) Has authority to negotiate and conclude contracts in your name, and regularly exercises that authority, or

2) Has a stock of your merchandise from which orders are regularly filled on your behalf. (Reg. 1.864-7(d)(1)(i)).

<u>Independent Agents</u> - An office or fixed place of business of a genuinely independent agent <u>will not</u> be attributed to you, regardless of whether the agent has authority to negotiate and conclude contracts in your name, and regularly exercises that authority, or has a stock of your merchandise from which orders are regularly filled on your behalf. (Reg. 1.864-7(d)(1)(ii).

CONFUSION ON OBTAINING US TAX ID NUMBERS (ITINs)

We previously mentioned three of the main US tax identification numbers for individuals and entities.

Corporations, partnerships, LLCs, estates and trusts obtain an "<u>employer identification number</u>" (EIN), even if there are no employees, by simply by filing IRS Form SS-4.

US citizens, green card holders, and other individuals with US visas that entitle them to work in the US obtain a US "<u>social security number</u>" by filing IRS Form SS-5 with the US Social Security Administration.

All other individuals obtain an "<u>individual taxpayer identification number</u>" (ITIN) by filing <u>IRS Form W-7</u> (Application for ITIN) with the Austin, Texas, branch of the IRS. However sometimes it's not so simple!

How to File IRS Form W-7 for an ITIN

Please see Exhibit 1.

Generally speaking you cannot file Form W-7 with the IRS to obtain an ITIN unless you are simultaneously filing IRS Form 1040NR (tax return), IRS Form 8288-A (remittance of tax on a real estate sale) or IRS Form 8288-B (application to reduce withholding tax on a real estate sale).

Actually, the IRS will not process 1040NR or 8288-B unless Form W-7 is attached, or unless a US taxpayer number has previously been obtained and is attached.

However Form W-7 can be filed without IRS Form 1040NR, 8288-A or 8288-B if you can demonstrate a "need" for the ITIN. See "***Applying for an ITIN on the Basis of Need***" below.

In any case, Form W-7 must always have certain "main" documentation attached, to be a complete application. See ""***Main*** " ***Documentation Required***" below.

"Main" Documentation Required

Regardless of which method you are using to file Form W-7 you must attach an original or certified copy of certain "main" documentation. See Form W-7 instructions for examples of acceptable "main" documentation. Additional "supplementary documentation" is required if you are "***Applying for an ITIN on the Basis of Need***".

EXHIBIT 1

Ways Of Obtaining An "ITIN" *

Are You Filing An Income Tax Return **OR** Selling Real Estate

YES → File Form W-7 With Form 1040NR, Form 8288-A, Or Form 8288-B.

↓ NO

EXCEPTION 1
Are You:
1. A Partner In A Partnership With US Tax Obligations,
2. A Recipient Of Certain US Bank Interest, or
3. A Recipient Of Distributions From Certain US Pensions, Annuities, Royalties, Dividends, Etc

YES → You May Be Entitled To Exception 1. See Exhibit 3.

↓ NO

EXCEPTION 2
Are You Claiming A Treaty Benefit With Respect To:
1. Wages Or Other Compensation, Or
2. Scholarship Or Similar Benefits, Or
3. Gambling Income

YES → You May Be Entitled To Exception 2. See Exhibit 5 For Wages.

↓ NO

EXCEPTION 3
Do You Have A Mortgage With A US Lender

YES → You May Be Entitled To Exception 3.

↓ NO

Contact The IRS Or Your Tax Advisor

* This Is A Brief Summary Only. Please Consult Your Tax Advisor.

The most common "main" documentation that individuals provide is a passport. If you provide a certified copy of your passport with Form W-7 attached to Form 1040NR, 8288-A, or 8288-B, no other documentation is required to obtain the ITIN.

However if you are supplying a "certified" copy of the passport (or other main documentation) it must be certified by:

1) The issuing Government, or
2) A United States notary or
3) A non-US Notary as outlined in the Hague Convention.

Non-US Notary - Hague Convention - (Apostille Format)

The United States and Canada are parties to the "Hague Convention Abolishing the Requirement of Legalization for Foreign Public Documents". That Convention abolishes the requirement of "diplomatic and consular legalization" for public documents originating in one Convention country and intended for use in another.

Thus, if it is inconvenient to have your passport (or other documentation) certified by a United States notary you can have a Canadian notary certify it, provided it is certified in the format of an Apostille as set out in the Hague Convention. A model of an Apostille certificate is provided in an annex to the Hague Convention, on the IRS website, and in Exhibit 2 attached.

EXHIBIT 2

Model of certificate

The certificate will be in the form of a square with sides at least 9 centimetres long

APOSTILLE

(Convention de La Haye du 5 octobre 1961)

1. Country: . . . .

This public document

2. has been signed by . . . .
3. acting in the capacity of . . . .
4. bears the seal/stamp of . . . .

. . . .

Certified

5. at . . . . 6. the . . . .
7. by. . . . .
8. N° . . . .
9. Seal/stamp: 10. Signature

. . . .

Applying for an ITIN on the Basis of Need (i.e. Without Form 1040NR, 8288-A, or 8288-B)

The instructions to IRS Form W-7 set out what are referred to as the "Four Exceptions". These are circumstances in which you can apply for an ITIN without simultaneously filing Form 1040NR.

Exception 1: "Withholding on Passive Income". If you are:

a) A partner in a partnership with US tax obligations, or

b) A recipient of certain US bank account interest, or

c) A recipient of distributions from certain US pensions, annuities, royalties, dividends etc.,

you can apply for an ITIN provided you attach the appropriate "supplementary documentation" to Form W-7 in addition to the "main" documentation. Please see Exhibit 3 (taken from IRS Publication 1915) for a list of potential supplementary documentation. See also Exhibit 4 for a sample "Letter From Withholding Agent" for potential use in b) above (also taken from IRS Pub. 1915).

Exception 2: "Claiming Tax Treaty Benefits". If you are claiming tax treaty benefits with respect to:

a) Wages or other compensation (Exception 2(a), see Exhibit 5), or

b) Scholarship or similar benefits, or

c) Gambling income,

you can apply for an ITIN provided you attach the appropriate "supplementary documentation". Please see Exhibit 5 with respect to wages and salaries. Please refer to IRS Publication 1915 and the instructions to Form W-7 with respect to scholarship or similar benefits, and gambling income.

Exception 3: "Reporting of Mortgage Interest". If you have a home mortgage from a US lender that is requesting a US tax ID number, you can obtain an ITIN without simultaneously filing an IRS tax Form provided you show evidence of the mortgage loan ("supplementary documentation"). This would include a copy of the purchase contract or similar documentation, showing evidence of a home mortgage loan.

Exception 4: "Sale of US Real Estate". As indicated above under ***"How to File IRS Form W-7 for an ITIN"***, you can apply for an ITIN along with the filing of Form 8288-A (remittance of tax on a real estate sale) or Form 8288-B (application to reduce withholding on a real estate sale). Actually, the IRS will not even process 8288-B unless Form W-7 (or a previously issued US tax number) is attached.

SETTLING US TAX FOR PENNIES ON THE DOLLAR?

By Robert S. Blumenfeld, Esq.
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"I am proud to be paying taxes in the United States. The only thing is that I could be just as proud for half the money." Arthur Godfrey.

At tax time we often read advertisements in the media from a number of companies that inform taxpayers who owe money to the IRS that they can settle their cases for "pennies on the dollar." This gives taxpayers the impression that these companies can push a magic button and tap into some kind of bargain-basement deal with the IRS. For the most part, this representation is not realistic. Unless a taxpayer is virtually totally bereft of income and assets, the chances of settling for a percentage of the actual tax due is extremely remote.

During my time at the IRS I came across one instance that shows an example of how

EXHIBIT 3

(Form W-7 Exception #1) Passive Income

Persons who are eligible to claim Exception 1 include:	**Documentation to be submitted by individuals who are eligible to claim Exception 1:**
1(a) Individuals who are partners of a foreign partnership that invests in the U.S. and who own assets that generate income subject to IRS information reporting and Federal tax withholding requirements; or	**1(a)** To support Exception 1(a), submit a copy of the portion of the partnership agreement displaying the partnership's EIN (Employee Identification Number) and showing that the applicant is a partner in a partnership that is conducting business in the United States.
1(b) Individuals who have opened an interest bearing bank deposit account that generates income which is effectively connected with their U.S. trade or business and is subject to IRS information reporting and/or Federal tax withholding; or	**1(b)** To support Exception 1(b), submit documentation from the bank that an interest bearing business account was opened that is subject to IRS information reporting and/or Federal tax withholding during the current tax year.
1(c) Individuals who are "resident aliens" for tax purposes and have opened up an interest bearing bank deposit account that generates income subject to IRS information reporting and/or withholding of Federal income tax; or	**1(c)** To support Exception 1(c), submit documentation from the bank stating that you are receiving distributions from a deposit account which are subject to IRS information reporting and/or withholding of Federal income tax during the current tax year. An acknowledged (signed by the Bank) copy of the Form W-9 that you provided to the Bank must be attached to Form W-7/W-7(SP).
1(d) Individuals who are receiving distributions during the current year of income such as pensions, annuities, royalties, dividends, etc., and are required to provide an ITIN to the withholding agent (i.e. investment company, insurance company, financial institution, etc.) for the purposes of tax withholding and reporting requirements.	**1(d)** To support Exception 1(d), submit documentation in the form of a signed letter or document from the withholding agent, on official letterhead, showing the individual's name and account number, and evidencing that the ITIN is required to make distributions to the individual during the tax year, which are subject to Federal tax withholding and/or reporting requirements.

this situation works, as well as the heart that the IRS shows in working with taxpayers. I was examining the returns of a person who had worked for a company that had fled the country with tens of millions of dollars of investors' money (including his own). The person under examination owed the United States government the tax on some $10 million. The money was gone (apparently with the fleeing company) and so the individual owed the IRS about $7 million. By the time I reached him, he was working as a schoolteacher in upstate New York, earning $25,000 a year, driving a 10-year old car, and living in a rental apartment. He had no other assets that I could find. Working with an Internal Revenue Service Revenue Officer, I concluded there was no way that this person could afford to pay even a penny on the dollar ($70,000) so we wrote the case off as totally uncollectible.

This however, is clearly not the typical situation. Suppose someone owes the government $100,000, but has a house, a car, a bank account, securities, and sundry other assets. Should this person be permitted to settle his liability for less than the full amount due? The IRS can and will put a lien on the property, seize the bank account and securities, and garnish the wages.

Thus, from the IRS perspective, only extreme cases warrant a "pennies on the dollar" resolution. Therefore, please be cautious in employing companies to achieve such results for you.

Bob Blumenfeld, spent more than 30 years in Washington at the Internal Revenue Service as a senior attorney.

DON'T OVERLOOK THE TREATY

Although Canada and the United States each has its own domestic tax law, the domestic provisions of each country can be overridden by the Canada-United States Income Tax Convention ("the treaty").

Ignoring treaty provisions may be costly since they can significantly alter the tax liabilities. Moreover, Canada may not allow you

EXHIBIT 4

Sample Letter From Withholding Agent
(To Be Used as a Guide for Providing Required Information)
(Written on Official Letterhead of Withholding Agent)

To: IRS
ITIN PROGRAM OFFICE

To: Whom it May Concern:

This is to certify that ______________________________
Name of Account Holder

has an account with this organization ______________________________
Account Number

which will be generating income during the current tax year that is subject to IRS information reporting and/or withholding of federal income tax. The applicant, therefore, is requesting an ITIN to provide to us for our reporting, withholding and distribution procedures.

Sincerely,

____
Printed Name of Official

______________________________ ______________________________
Date of Signature Signature of Official/Official stamp

a tax credit for any US tax you pay in excess of the least amount of US tax due under the treaty.

However not everyone can claim benefits under the treaty. For example certain portions of the treaty do not apply to US citizens and US residents. See Article XXIX(3) of the treaty - the so-called "Saving Clause". The Saving Clause also applies to certain residents of Canada.

Article II of the treaty sets out the type of taxes in each country affected by the treaty.

The *Canadian* taxes affected are: "the taxes imposed by the Government of Canada under the Income Tax Act".

The *United States* taxes affected are:

1) Federal income taxes imposed by the Internal Revenue Code,

2) The accumulated earnings tax to a limited degree related to dividends,

3) The excise tax on Private Foundations, to a limited degree,

4) The US estate tax to a limited degree, and

5) US social security tax, but only to the extent of providing a foreign tax credit to certain Canadian residents.

Some of the issues covered by the treaty are as follows:

Article IV of the treaty addresses the issue of residency for individuals, corporations and trusts. It is especially relevant when an individual meets the residency rules of Canada and the US in the same year - i.e. when the individual is a "dual resident".

It is Article V that contains the definition of a "permanent establishment", the factor that can often determine whether or not your Canadian business is subject to US income tax.

Articles VII, X, XIV and XVI of the treaty have provisions (among others) relating to business profits. Article VII contains the provision exempting the profits of a resident of one country from income tax in the "other country" if there is no "permanent establishment" in the "other country". Article X provides certain benefits against the US corporate "branch tax". Article XIV (somewhat like Article VII) protects certain self employed residents of one country against tax in the other country on their business income in the other country. For certain Artists and Athletes that are residents of one country, Article XVI limits their tax in the other country.

EXHIBIT 5

(Form W-7 Exception #2a) Wages Or Other Compensation

Persons who are eligible to claim Exception 2(a) include:	Documentation to be submitted by individuals who are eligible to claim Exception 2(a).
■ Individuals claiming the benefits of a tax treaty who are either exempt or subject to a reduced rate of withholding of tax on their wages, salary, compensation and honoraria payments, and Who will be submitting Form 8233 to the payer of the income.	■ A letter of employment from the payer of the income, or ■ A copy of the employment contract, or ■ A letter requesting your presence for a speaking engagement, etc. along with: ■ Information on the Form W-7/W-7(SP) application that the person is entitled to claim the benefits of a tax treaty, and ■ A copy of the completed withholding agent's portion of Form 8233 attached to the Form W-7/W-7(SP), and a letter from the Social Security Administration (SSA)*, stating that the individual is ineligible to receive a Social Security Number. * Individuals present in the U.S. who are receiving honoraria payments, do not have to obtain a letter of denial from the SSA. A letter from the Authorized School Official will suffice.

Article XIII addressing capital gains can be helpful in several different circumstances. Among other matters a partial exemption is provided on certain real estate gains accruing before 1985 and assistance is provided for individuals moving from one country to the other.

Article XV is commonly invoked because it addresses the circumstances where an employee resident in one country works temporarily in the other country.

Article XVIII, addressing "Pensions and Annuities", covers, (among other things) the cross-border taxation of Canadian Old Age Security, Canada/Quebec Pension plan, and US Social Security. It also provides the election that defers current taxation of income accruing inside RRSPS, RRIFs (and other pensions in each country). The cross-border taxation of alimony is also covered in Article XVIII.

Cross-border rules for individuals employed by Governments, and rules for students, are set out in Articles XIX and XX, respectively.

Article XXII contains, among other things, the rules for obtaining refunds for tax collected at source on certain gambling activities.

Article XXIV is entitled "Elimination of Double Taxation". Paragraphs 4, 5 and 6 of Article XXIV contain some challenging rules addressing the foreign tax credit complexities that can arise, for example, when a US citizen or green card holder, resident in Canada, receives taxable income from both countries. Paragraph 7 provides residents of Canada with a potential foreign tax credit for US individual State and City taxes.

Article XXIX contains the Saving Clause (paragraph 2) mentioned above, whereby each country retains the right to tax its residents (and citizens in the case of the US) as if there were no treaty at all, (subject to the exceptions provided in paragraph 3).

Article XXIXB is the section that provides certain Canadians with substantial relief from US estate tax. Potential relief is also provided against the final Canadian income tax liability of a Canadian resident whose estate is subject to US estate tax.

SALE OF US REAL ESTATE BY A CANADIAN NON-GRANTOR TRUST

Computing the Gain (Cost Base Rules for a Non-Grantor Trust)

For a summary of other rules for foreign non-grantor trusts, please refer to the Winter/Spring, 2006, issue of the Taxletter.

The gain stemming from the sale of US real estate will normally be determined, at least in part, by the difference between the net sales proceeds and the adjusted cost base ("adjusted basis" in US terminology), hereafter referred to as "basis".

A non-grantor trust's basis in its property will be determined from how it acquired the property (i.e. generally by purchase, gift, or death).

Purchase. - Of course if the trust actually purchased the property, the starting point to calculate basis will be the actual cost of the property. Certain "closing costs" and permanent improvements will be added.

Gift. - If the nonresident alien creating the trust gifted the property to the trust, the starting point to calculate basis will usually be the basis of the property in the hands of the individual giving the property (the "donor"). Subsequent permanent improvements can be added.

The US does not generally have a "deemed disposition" on such transfers by nonresident aliens. Thus if the property's value at the date of gift exceeds its basis for the donor, the basis for the trust will remain at the lower value. Any US gift tax paid may be included.

Death. - The rules for determining the trust's basis in property acquired from a decedent are problematic. The result depends upon how the trust acquired the property. If the trust acquired the property from an individual as a result of his/her death, the basis may be the fair market value at the date of death (or six months later if elected). (See Code Section 1014(a)(1)). This situation may arise if an individual creates a revocable "grantor trust" during lifetime that becomes an irrevocable trust at the time of his/her death.

Distribution of the Real Estate to a Beneficiary

A separate set of issues arises if the trust distributes appreciated real estate to a beneficiary other than pursuant to a bequest. In some cases the distribution may trigger tax to the trust or the beneficiary. In other cases where tax is not triggered, the trust may elect to have it triggered. In this case, the basis of the property to the beneficiary will be the basis to the trust plus any gain realized by the trust.

CANADIAN CORPORATIONS, FORM 5471, AND CURRENCY TRANSLATIONS

If you are a US citizen or US resident (including a green card holder living in Canada) and you own a private Canadian (or other non-US) corporation you must file IRS Form 5471. On that Form you must include, among other items, the balance sheet and income statement of the corporation. We previously warned of the potential $10,000 penalty for failure to timely file this Form.

Some of the figures on the Form must be presented in US dollars and others must be presented in the corporation's "functional currency". So, before beginning to prepare the Form you must determine the corporation's "functional currency".

Functional Currency

Section 985 of the tax code provides that a corporation's "functional currency" is:

1) "the US dollar, or

2) in the case of a qualified business unit, the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records".

Thus for many Canadian corporations owned by US citizens or US residents the functional currency is the Canadian dollar.

However the functional currency of a Canadian or other foreign corporation is the US dollar if the activities of the unit are primarily conducted in US dollars. Also, in certain cases a corporation can elect to use the US dollar as its functional currency.

If the functional currency is different than the US dollar you will be required to use certain prescribed "currency translation rules".

Currency Translation Rules

If the functional currency of the corporation is not the US dollar certain currency translations are required since some information on Form 5471 is required in US dollars even if the functional currency is not the US dollar.

Income Statement - According to Code Section 987 the income statement is translated from the functional currency to the US dollar at the "appropriate exchange rate ....".

Code Section 989(b)(4) legislated in 1986 originally stated (in part) that in the case of the income statement the "appropriate exchange rate" means the "weighted average exchange rate during the year". However apparently there was confusion over the meaning of "weighted" average.

Treasury Regulation 1.989(b)(1) issued in 1989 and amended in 1991 states "weighted average exchange rate" means the simple average of the daily exchange rates ....".

As of January, 1998, Code Section 989(b)(4) was amended to state the appropriate rate for the income statement is the "average exchange rate for the taxable year" of the corporation.

Dividends are to be translated at the spot rate on the date the dividend is included in income (IRC 989b)(1)), and income included under Section 951 (e.g. subpart F income) is translated at the average exchange rate for the taxable year of the corporation.

Balance Sheet - US Generally Accepted Accounting Principals (GAAP) provide two major methods of currency translation:

1) The Current Rate (or Closing Rate) Method, and

2) The Temporal Method.

Under the current rate method all assets and liabilities are translated at the current (i.e. year end) exchange rate. The Stockholders' Equity section is translated at historical rates.

The difference in the translation rates used for assets and liabilities, on one hand, and the income statement and shareholders' equity on the other hand, creates an "imbalance" that is classified as a "translation adjustment" on the balance sheet. This is an unrealized gain or loss that is taken into consideration when the corporation is sold and the proceeds are converted into US dollars.

Under GAAP, in most cases an assumption can be made that income and expense items occur evenly throughout the accounting period and a "weighted average-for-the-period exchange rate can be used".

PASSIVE FOREIGN INVESTMENT COMPANIES(PFICs)

If you are a US citizen or US resident (including a green card holder living in Canada) you may already have a US tax "skeleton" if you own a "PFIC".

A Canadian mutual fund that is organized as a corporation, or a Canadian private corporation, might constitute a "PFIC" (passive foreign investment company) under US tax rules. If you have a PFIC you might have a prior US tax liability or a potential one that is larger than you anticipate. The description of a PFIC is set out below under ***"Definition of a PFIC"***. Special rules apply if the PFIC is also a "controlled foreign corporation" (CFC).

If you own a PFIC that is not a CFC an unusual US tax liability can arise if:

1) You sell all or part of your stock, or
2) You receive a dividend from it.

(See IRC 1291).

Sale of Stock of a PFIC - If you sell the stock of a PFIC your profit is spread back over all the post-1986 years you owned the stock.

1) You are then taxed on the gain allocated to each prior year at the highest ordinary income tax rate in effect for that year, and

2) You are charged compound interest on the tax allocated to prior years as if the tax had been payable for that prior year.

Special rules apply if the PFIC is also a CFC.

Dividends from PFICs - To determine if you have a US tax issue with respect to a dividend from a PFIC you proceed as follows:

a) Compute the average dividend you received from the PFIC in the preceding 3 years, (or, if shorter, your holding period before the taxable year),

b) Multiply a) above by 125%,

c) Subtract the amount in b) from the actual dividend you received in the current year. The result is called "total excess distribution".

As in the case of a sale of stock above, this "excess distribution" is then spread over all the post-1986 years that you owned the stock, and

1) The amounts allocated to years prior to the current year, are taxed at the highest tax rate in effect for those years, and

2) The IRS charges back interest on the tax allocated to prior years as if the tax had actually been payable for that prior year.

Special rules apply if the PFIC is also a CFC.

However an exception may apply to the above rules if:

1) You elect to "mark to market" in the case of marketable stock (e.g. a corporate mutual fund), or

2) You elect to treat the PFIC as a "qualified electing fund" ("QEF").

Exception for Mark to Market Election

You may avoid the regular PFIC rules if you elect to include the annual appreciation (or depreciation) in the value of the shares in your taxable income. Once you make the election it applies to future years unless you obtain IRS approval to revoke the election. (IRC 1296).

Thus, in the case of a mutual fund, you would simply determine the year end value each year and report the increase or decrease in value for that year on your tax return and adjust your cost basis of the stock up or down accordingly.

The increase or decrease in value of the shares, as the case may be, is ordinary income, or ordinary loss. Any loss is deductible in computing adjusted gross income for that year. (IRC 1296(c)(1)).

Major Benefit for New US Residents. - Non-US citizens that become new residents of the United States are the beneficiaries of an extremely helpful rule that gives them a "step up in cost basis" in their PFIC shares to the fair market value at the beginning of the year in which they become US residents. (IRC 1296(l)).

Exception for Qualified Electing Fund (QEF)

You can also avoid the regular PFIC rules, prospectively, if you choose to treat the corporation as a "qualified electing fund". In this case you are taxed personally each year on your share of the PFIC's "ordinary" earnings at your ordinary tax marginal tax rate, and you are taxed on your share of the PFIC's capital gains at your long term capital gains tax rate. Once made, the election generally continues for future years. (IRC 1293).

If you do not receive sufficient distributions from the PFIC to pay the tax on this "deemed " taxable income you can elect to defer payment of the tax, but an interest charge will apply. (IRC 1294). This payment deferral election is made on a year to year basis.

If the QEF election was not made for the first year, the PFIC "taint" remains for the earlier years.

Purging the PFIC Taint - If you have shares in a PFIC for which you have never made the QEF election, or if you made the QEF election in a later year, it may be beneficial to "purge" the PFIC taint. This can be done either by a mark to market election or by a "deemed dividend" election (the latter only available to PFICs that are also CFCs).

Once you have purged the taint you have a "pedigreed QEF"

Pedigreed QEF

A pedigreed QEF is a PFIC that was always a QEF or that has been purged (see "Purging the Taint", above. A pedigreed QEF is not subject to the special tax rules applicable to PFICs rules. Other rules apply.

Definition of a PFIC

With limited exceptions, a passive foreign investment company (PFIC) is any foreign corporation where:

1) 75 percent or more of the gross income for the year is passive income, or

2) The average percentage of assets held by the corporation during the year which produce passive income or which are held for the production of passive income is at least 50%.

However the corporation will not be "treated" as a PFIC with respect to you, during any period the corporation is a controlled foreign corporation (CFC) of which you are a "United States shareholder".

US TAXATION OF NONRESIDENT ALIENS

Section 871 of the US Internal Revenue Code is an important section of the US tax law that addresses the US taxation of nonresident aliens. It is divided into separate parts, such as the tax on:

1) Income that is not connected with US business,

2) Income that is connected with US business,

3) Real estate rental income,

4) Capital gains, and

5) Certain other types of income such as: certain annuities under qualified plans, original issue discount interest, certain dividends from Regulated Investment Companies, and income received by participants in certain exchange or training programs.

In many of these cases, the rules of the tax code are overridden by the rules of the tax treaty between Canada and the US ("the treaty").

1) Income that is not Connected with US Business

When not connected with US business, a US tax of 30% is generally (but not always) imposed on gross income from interest, dividends, rents, salaries, certain gambling winnings, social security benefits, wages, premiums, annuities, compensation, remunerations, and other "**F**ixed or **D**eterminable, **A**nnual or **P**eriodical gains, profits, and **I**ncome" (referred to as "FDAPI" in the lingo of the trade!).

This requirement is "enforced" via Sections 1441 and 1442 of the tax code that impose "withholding at source" obligations on the "payers" of the income (section 3402 in the case of salaries paid to employees). If the proper tax is not withheld at source, the recipient is required to file a US income tax return to pay the tax (or claim a refund if excessive tax was withheld).

Having set the above general rule, the tax code then provides exceptions. Some of the exceptions are, in turn, overridden (improved upon) by the treaty.

Interest - For example, under the tax code interest received from banks and Savings and Loan Associations is exempt if it is not connected with US business, as is interest on amounts held by an insurance company under an agreement to pay interest thereon.

Also, if it is not connected with business, income from "portfolio debt" is exempt, provided it is not received by a "10-percent shareholder". Most recently-issued public corporate debt and US Treasury securities qualify as "portfolio debt". (Check the prospectus or have your broker confirm, to be sure). A "10-percent shareholder" means a shareholder of a corporation, or partner in a partnership, respectively, that owns 10% or more, or shares in 10% or more of the profits. (IRC 871(h)).

Where the 30% tax on interest would otherwise apply, the rate is instead reduced to 10% under the treaty for residents of Canada.

Dividends - Similarly, when a tax of 30% would otherwise apply to dividends paid to Canadian recipients, it is reduced to 15% under the treaty (sometimes 5% for Canadian corporations owning 10% or more of the US paying corporation).

Rents - Rental income from personal property and real property is subject to the 30% rule when it is not connected with US business. However a special election is available for real property (real estate) income to avoid the 30% rule. (See Real Estate Rental Income, below).

Gambling Winnings - When not connected with business, the 30% tax applies to gambling winnings except for winnings from: blackjack, baccarat, craps, roulette, or big-6 wheel. Under the treaty, Canadians are entitled to deduct losses on taxable games against taxable winnings.

Social Security Benefits - Under the tax code, only 85% of US social security benefits are subject to the 30% tax. However under the treaty, residents of Canada are exempt US tax on US social security payments (and are only taxed in Canada on 85% of the payments).

2) Income that is Connected with US Business

Income that is connected with US business is generally subject to US tax on the net profit at the graduated tax rates set out in Section 1 of the Internal Revenue Code (Section 11 for corporations). Thus, not only typical business income, but also interest and dividends are subject to tax at graduated rates if they are connected with US business.

Of course in either case, if there is no "permanent establishment" in the US, there is a potential exemption from tax under the treaty on income connected with business (but not on "FDAPI" income).

3) Real Estate Rental Income

The taxation of real estate rental income depends upon the nature of the activity and, in some cases, upon whether you make a special tax code election.

When the rental activity is substantial, such as the operation of a large apartment complex and/or when the participation by you is significant, you will be considered to be engaged in US business. Therefore you will be taxed as in paragraph 2) above, at graduated tax rates on your net profit.

On the other hand, when the activity is minimal, and/or where the participation by you is trivial, perhaps in the case of a triple net lease on a small office building, or a residential condominium, where all the activity is handled by an agent, you may not be considered to be engaged in US business. Thus, you could be subject to US tax at a flat 30% rate on the gross rental income as set out in paragraph 1) above. But if you wish, you may make an election under Section 871(d) of the tax code, to treat the rental income "as if" you are engaged in US business, and thus be taxed at graduated tax rates on the net profit instead of 30% on the gross rents.

4) Capital Gains

Generally - Except for real estate gains, the tax code provides that a nonresident alien is subject to tax at 30% on US source capital gains if he/she is present in the US 183 days or more during the year. (Section 871(a)(2)). However individuals resident in Canada are generally exempt from this rule due to the treaty. (Article XIII(4) and (5)).

Real Estate Gains - a special rule for all nonresident aliens treats real estate gains "as if" they are connected with US business. (Section 897). Thus, such gains are taxed at graduated tax rates, but subject to a special maximum rate (sometimes 15% for individuals and trusts) if the property was owned for more than 12 months.

US FEDERAL ESTATE TAX FILING REQUIREMENTS

Readers are aware the United States imposes a federal estate (death) tax. This article sets out the "filing threshold" for an estate tax return (i.e. the level of assets you must own to trigger an estate tax filing requirement). The filing threshold is completely different depending upon whether you are a US citizen or domiciliary (on the one hand), or whether you are a nonresident alien.

However even if there is a requirement to file an estate tax return, there may not be any actual estate tax payable after considering the various deductions and credits available to you. Nonetheless, failure to file can have unfortunate results later.

Some individual States impose a separate estate tax. (Please see ***"VARIED "STATE" RULES ON ESTATE TAX"***).

Nonresident Aliens

The estate of a nonresident alien decedent must file a US federal estate tax return if the gross value of the "US situs" property owned by the decedent exceeded US $60,000 at the date of death. (IRC 6018(a)(2)).

"US Situs" Property - United States real estate and related furnishings, equipment, artworks, etc. are of course, US situs property. Also included (among other things not mentioned) are the shares of US corporations (and stock options), equity golf memberships, certain debt of US borrowers, US pension plans that continue after death, and boats or vehicles that remain in the US.

Jointly Owned Property - When US situs property is jointly owned by nonresident alien spouses, (WROS), the entire (gross) value of the property (not just the decedent's share) is used to determine if there is a filing requirement - i.e. if the $60,000 threshold is reached.

US citizens and US Domiciliaries

For deaths in 2006 and 2007, a US federal estate tax return is required for US citizens and US domiciliaries only if the "gross estate" exceeds the "applicable exclusion amount as determined in Internal Revenue Code Section 2010(c)". (IRC 6018(a)(1)).

"Gross Estate"

The gross estate for citizens and domiciliaries is defined in Code Sections 2031-2046. Simplistically, all assets, wherever situated, are part of the gross estate. However, less obvious items such as life insurance proceeds, pensions that continue to a surviving spouse, and certain interests or powers in trusts are also included.

"Applicable Exclusion Amount"

Under Code Section 2010(c) the "applicable exclusion amount" for 2006 and 2007 is US $2 million. However the "applicable exclusion amount" must be reduced by certain prior taxable gifts that were made (if any). (IRC 6018(a)(3)). Prior gifts were only taxable to the extent they exceeded the annual exclusion amount (approximately US $12,000 per year per donee in recent years).

Thus, for an individual that passed away in 2006, that was a US citizen or US domiciliary, a US federal estate tax return is only required if the gross estate of the individual exceeded an amount equal to US $2 million reduced by certain prior taxable gifts.

VARIED "STATE" RULES ON ESTATE TAX

The abolishment of the "State Tax Credit", (that was previously available as a deduction from US federal estate tax), caused individual States to react in different ways. Some States changed their legislation to ensure they continue to collect some estate tax. In other cases the State estate tax simply lapsed.

In Florida, for example, the State estate tax liability lapsed (as of January 1, 2005). Oddly, however, the requirement to file a Florida estate tax return still exists (assuming the decedent's assets are above the filing threshold). Thus a Florida estate tax return must be filed if the decedent:

1) owned Florida real estate, or other tangible property domiciled in Florida that exceeded the filing threshold, or

2) was resident in Florida.

If you file a Florida estate tax return the State will issue a Florida Nontaxable Certificate which can be recorded in the County records (along with the federal tax clearance) to avoid difficulty on the future sale of the property.

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