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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ADMINISTRATIVE/LEGISLATIVE/ JUDICIAL UPDATE

US Senate Ratifies 5th Protocol to the Tax Treaty

On September 23rd the U.S. Senate ratified the 5th Protocol to the Canada-US tax treaty. All that remains for the Protocol to go into force is for the two Governments to exchange instruments of ratification.This may happen by the time you receive this Taxletter.

No Exclusion for Airline Pilot

A US citizen airline pilot who resided in the French West Indies and France did not qualify for the "foreign earned income exclusion" on his US income tax return because his "tax home" was not in a foreign country. An individual's "tax home" is generally the individual's "place of employment" (unless the individual does not work, in which case it may be the individual's "regular place of abode"). The court held that the pilot's place of employment was his "base airport", which was in the US. (P.A. Brunet, TC Summary Opinion 2008-96).

Florida Explains Use Tax for Boats

Florida has advised if a boat is purchased outside of Florida and used under conditions that give rise to the taxing jurisdiction of other US States for six months or longer before being brought into Florida, and presuming the boat was not bought for original use in Florida, it will not be subject to Florida sales or use tax when brought to Florida for use.

No Missouri Sales Tax on Downloaded Photographs

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 37 YEARS.

The Missouri Department of Revenue has ruled that the sales of downloadable copyrighted photographs over the Internet by a website-based business are not subject to Missouri sales tax if there is not a transfer of tangible property involved. (Missouri Letter Ruling LR 5058, August, 2008).

Distinguishing "Custom" and "Prewritten" Software

In many States, the sale of computer software may be subject to sales tax if it is "prewritten" software, but exempt if it is "custom" software. In a recent Wisconsin case the court had to decide if modular software that was made up of "standard software modules" and mass marketed to thousands of different businesses was "prewritten" or "custom". It was decided the software was "custom" because, among other factors, the system always had to be modified to fit a particular client's needs. (Wisconsin Dept. of Revenue v. Menasha Corp. Wisconsin Supreme Court, No. 2004AP3239, July 11, 2008).

Illegal Deduction Elimination Act (IDEA)

Legislation has been introduced in the US Congress (H.R. 6813) to make it clear that wages paid to "unauthorized aliens" may not be deducted when computing taxable income. The change would be made by amending Code Section 162, which addresses illegal bribes, kickbacks, and other payments.

IRS Focuses on Foreign Athletes and Entertainers

The IRS has launched an "Issue Management Team" focused on improving US income reporting and tax payment compliance by foreign athletes and entertainers who perform in the United States. The initial focus is on those engaged in tennis, golf and music.

Entertainers and athletes who perform or participate in events in the US can request a "Central Withholding Agreement" (CWA) from the IRS, which may lower the withholding rate below the normal 30%. A CWA can be filed for a single individual or multiple entertainers. (See IRS Form 13930).

IRS Warns Against Late Filing of Form 5471

The IRS has begun issuing warnings to certain US corporate taxpayers that filed IRS Form 5471 after the due date. The IRS has announced that beginning January 1, 2009, the IRS Service Center will automatically levy appropriate penalties on late filed corporate income tax returns (Forms 1120) with Forms 5471 attached. The penalty is generally $10,000. IRS Form 5471 is also required by US citizens and green card holders who have a prescribed degree of involvement with a non-US corporation.

California Sales Tax

An out-of-State company has "nexus" in California for sales tax purposes if it has a "salesperson" engaged in authorized selling activities on behalf of it. A link on the seller's affiliate's website may not suffice to establish that the affiliate is an "authorized salesperson" unless the affiliate engages in promoting the link.

Disregarded Entities Selling Realty May Not Avoid US Withholding

As a general rule, there is no US (FIRPTA) tax withholding at source when a domestic (US) entity sells US real estate. Therefore, for example, a non-US person might consider forming a solely owned US LLC to own US real estate, and then making the "check the box election" (IRS Form 8832) to ensure the entity is treated as a "disregarded entity". Upon sale of the property the foreign owner may consider there is no withholding tax at source because the seller is a domestic entity.

However, in Letter Ruling 200836029, issued August 6, 2008, the IRS ruled that a disregarded entity cannot certify that it is the transferor for purposes of the sale and withholding. (See also Reg. 1.1445-2(b)(iii)). Thus the owner of the disregarded entity is treated as the seller.

Wyoming Sales Tax on "Third Party Drop Shipping"

If a "vendor" purchases a product from a "supplier" and, to avoid double shipping, arranges for the product to be shipped directly from the "supplier" to the vendor's "customer" in Wyoming, there is no Wyoming sales tax on the first transaction if the "vendor" provides the "supplier" with a properly completed "Exemption Certificate". (See the article ***"STATE SALES TAX EXEMPTION CERTIFICATES FOR CANADIAN BUSINESSES").***

Further, if the "vendor" is not required to hold a Wyoming sales/use tax license, it is not required to collect and remit Wyoming's sales tax on the sale to the customer. However the "customer" must pay Wyoming "use tax" (unless, of course, the product is exempt). (Sales tax bulletin #20, August 1, 2008).

IRS Reminds Partnerships

The IRS issued a "reminder article" to domestic and foreign partnerships engaged in a US trade or business, that have foreign partners. The IRS will treat each foreign partner as being directly engaged in the same trade or business for US federal tax purposes as the partnership itself. Each foreign partner must file the appropriate US income tax return.

Caution for US Citizens in Canada with NSULCs

US citizens and US residents that solely own Nova Scotia or Alberta Unlimited Liability Companies are generally required to file IRS Form 8858 (Information Return of US

Persons with Respect to Foreign Disregarded Entities). An exception would apply if the corporation has filed IRS form 8832, electing to be taxed in the US as a corporation. The potential penalty for noncompliance is $10,000. (See Code Section 6038).

Delivery of DVD Subject to Use Tax (Not Sales Tax)

An out-of-State corporation that sells software, which is delivered by DVD, to a Missouri client for use in Missouri is not subject to sales tax on the seller, if the seller does not have "nexus" in Missouri. However the customer is subject to Missouri "use" tax. (Letter Ruling # LR4920, July 3, 2008).

Florida Changes Rules for Personal Property Tax Returns

Under Florida State statues, Florida Counties levy a "tangible personal property" tax (separate from the "real property" tax) on tangible personal property that is used in business or in rental property. Beginning for 2008 the State has introduced a $25,000 exemption. However the Counties are not implementing the exemption uniformly. For 2008, a personal property tax return is still required in each County. However the form to be filed varies, depending on the County.

In some Counties a new Florida tax Form (Form DR-405) can be filed and it will be considered an application for the exemption amount. However if the value of your tangible personal was $25,000 or less on January 1, 2008, and you added no property since January 1, 2007, you are eligible to file a very simple exemption Form (DR-405EZ). In this case you are not required to file a tangible personal property tax return in future years until the value of the personal property exceeds $25,000.

In other Counties you may be required to file the same personal property tax form as prior years, and the County will make a determination on the exemption. Also, in at least one County, the prior return has already been examined for you by the County, and the exemption implemented automatically by the County.

Please check with the individual County for the rules in your circumstances.

"MARITAL STATUS" FOR US INCOME TAX

We previously mentioned the circumstances under which individuals are considered married for US income tax purposes, including individuals who are living "common law" in Canada or the US. Please see the Winter-Spring, 2008 Taxletter.

But what is the US income tax status of individuals that were considered "married", (including a "common law" marriage), for Canadian income tax purposes, and are now considered "separated" for Canadian purposes? For US income tax purposes, are these individuals considered "married" or "unmarried" ("single")?

In the US there can be considerable tax significance to the difference between being married and single because of the different US tax rate schedules. Unlike Canada, the US tax form does not have a tax status as "separated'. Therefore people who are "separated" must determine whether they are "married" or "single" (or "head of household") for US purposes, if they are required to file a US income tax return.

A "married" individual who is a US citizen or green card holder (or other US resident) and does not file a joint US return is subject to a higher tax rate than an individual in similar circumstances who is "single". Some different US tax rules even apply to nonresident aliens that are "married" compared with those who are "single".

The tax code provides, generally, that an individual who is "married" at the close of the tax year will be considered "married" unless the individual is "legally separated under a decree of divorce or separate maintenance". (An exception applies for certain married individuals living apart who maintain a home as the principal place of abode for a child, and other conditions are met. See IRC 7703(b)). Another rule permits a US citizen or US resident married to a nonresident alien to file as "head of household" (instead of "married) if other requirements are met).

The "decree" (i.e. an "authoritative order having the force of law") must expressly require the parties to live apart in the future. A decree of support or temporary alimony alone, with no accompanying requirement of separation, is not considered sufficient. A voluntary separation under a voluntary separation agreement does not constitute legal separation for this purpose, nor does an interlocutory (not final) decree. (Boyer v. Commissioner 732 F.2nd, 191, and Kellner v. Commissioner, 468 F.2nd 627).

Therefore it is likely that many Canadians living in Canada who file a Canadian income tax return as "separated" must consider themselves as "married" (rather than "single") on any US income tax return they are required to file.

WHAT IS "THE COMPETENT AUTHORITY"?

One purpose of the Canada-US tax treaty is to attempt to help taxpayers avoid double tax. However occasionally the tax administrators in each country will disagree with each other on the interpretation of the treaty. When they disagree, each country may try to collect the primary tax on a cross-border transaction. This may result in the potential for double tax notwithstanding the intention of the treaty.

The "Competent Authority" is the department of the Government's tax administration to which you apply, to attempt to have your conflict on the interpretation of the treaty resolved with the other country. In the US, applications are made to the "Deputy Commissioner (International)" of the Internal Revenue Service. Thereafter the "Competent Authorities" of the two countries will negotiate to resolve the issue.

However, in recent years the high level of cross-border activity between Canada and the US has resulted in a large backlog of unresolved cases. This prompted the addition of a new provision to the tax treaty, which is included in the 5th Protocol. Under the new provision, any case that has been unresolved for 2 years will be resolved under mandatory arbitration. Under this procedure each country will appoint one arbitrator and the two countries will mutually agree on a third arbitrator. Each country will then submit a proposal and the arbitrators must select one of the proposals. The only other countries with which the US has mandatory arbitration provisions are Germany and Belgium.

The US rules contain a "Small Case Procedure" that you can use for requesting "Competent Authority" assistance if you meet the "small case" standards. If you qualify under the "Small Case Procedure" the extent of the documentation you must submit can be substantially reduced. Please see Revenue Procedure 2006-54. Among other tax issues, the Small Case Procedure may be helpful in sorting out "residency" in the case where taxpayers believe they have been erroneously treated as a nonresident of the US by Canada.

Individuals can use the "Small Case Procedure" if the "proposed adjustment" does not exceed $200,000. For corporations and partnerships it cannot exceed $1 million.

HOW TO BUY A GREEN CARD!

The US immigration laws contain a rule under which a nonresident alien can obtain a green card by making an investment in a US business and hiring employees. Many individuals who have the funds to take advantage of this program are reluctant to do so, because, among other reasons, they:

1) Do not want to be involved in administering a business,

2) Might not qualify for US health insurance,

3) Are concerned about their exposure to United States estate tax, or

4) Determine their exposure to Canadian departure tax is too painful.

However the first two negatives can perhaps be addressed. From time to time entrepreneurs have formed "investment funds" through which an individual can invest, with other like-minded individuals, in a separate entity which makes the investment in the US "business" instead. Thus each of the investors can potentially qualify for a green card.

Recently such a venture was approved near Orlando, Florida, through which a nonresident alien that can apply for a green card by investing $1 million in a Limited Liability Company which in turn owns condo-hotel units situated about 1 mile from Disney World. The hotel unit units will be placed in an income generating program. The investor thus obtains an "investment" as well as a route to a green card.

In addition, the venture intends to apply to enroll in a group health insurance plan to cover investors in the project.

CANADA PENSION PLAN CONTRIBUTIONS & TAX CREDITS FOR US CITIZENS

Section 901 of the US Internal Revenue Code generally permits US citizens and residents to elect to offset against their US income tax liability a prescribed amount of any income tax paid or accrued during the year to a foreign country. Of course there is an extensive set of applicable rules.

The regulations provide that a foreign levy will not constitute a tax for this purpose to the extent the person subject to the levy receives (or will receive) a "specific economic benefit" in exchange for the payment (Reg. 1.901-2(a)(2)(i)). A "specific economic benefit" is defined in Regulation 1.901-2(a)(2)(ii)(B).

Regulation 1.901-2(a)(2)(ii)(C) provides that "a foreign levy imposed on individuals to finance retirement …….. *is not a requirement of compulsory payment in exchange for a "specific economic benefit"* (emphasis added) as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis for reflecting the respective ages, life expectancies or similar characteristics of such individuals".

Hence, superficially, social security type taxes paid to a foreign country can potentially be eligible for foreign tax credits in United States. However buried in Section 317(b)(4) of the US Social Security Amendments Act of 1977 (P.L. 95-216) is a provision that states the social security taxes paid by an individual to a foreign country will not be deductible by, or creditable against the income tax of, any such individual where an agreement pursuant to Section 233 of the US Social Security Act has been entered into between the US and that foreign country. (i.e. where the US has entered into a "Social Security Totalization Agreement" with the foreign country).

Of course the US does have a Social Security Totalization Agreement with Canada, and therefore Canadian social security taxes (e.g. Canada Pension Plan contributions) cannot be used as foreign tax credits on a US federal income tax return.

Article XXIV of the tax treaty between Canada and the US addresses foreign tax credits available in the United States. However with respect to Canadian taxes, the treaty only covers taxes imposed in Canada under the Canadian Income Tax Act (Article II(2)(a)). Since Canada Pension Plan contributions are levied under the Canada Pension Plan Act, not the Income Tax Act, they are not covered by the treaty.

On the other hand, residents of Canada may be potentially entitled to take a foreign tax credit on their Canadian income tax return for Social Security taxes paid to the United States. (See Treaty Article XXIV(2)(a)(ii)). See also the article ***"US SOCIAL SECURITY CONTRIBUTIONS & TAX CREDITS FOR CANADIAN RESIDENTS"***

STATE SALES TAX "EXEMPTION CERTIFICATES" FOR CANADIAN BUSINESSES

Individual State tax matters are becoming an growing part of "international tax" issues due to the expanding number of Canadian and other non-US businesses that are beginning to conduct business in the US.

In prior Taxletters we mentioned some US State sales tax matters but we did not describe applicable US State sales tax issues if you are a Canadian business that:

1) Sells a product (or a service) to a US customer that resells it to another US customer, or

2) Purchases a product (or, technically, a service) in the US from a US supplier that you resell in the US.

1) You Sell a Product

If you are a Canadian business and have "nexus" and "physical presence" in a State in which you sell a non-exempt product or service, you are generally obligated to collect sales tax on sales to customers in that State. However an exception may apply if you obtain a valid "exemption certificate" from your customer. This is potentially available, for example if your customer is not the "end user, in which case the exemption certificate is often referred to as a "reseller certificate". As a seller, the exemption certificate you obtain will normally be one of two types.

i) Uniform Sales & Use Tax Certificate - Multijurisdiction

Individual US States have formed the "Multistate Tax Commission" (MTC). The MTC has developed a "Uniform Sales & Use Tax Certificate - Multijurisdiction". A total of 38 States have indicated this uniform "Certificate" is acceptable for use in verifying that your customer is exempt from sales tax, including the circumstances where your customer intends to resell the product.

Therefore, for the States listed on the Certificate it may be adequate to have your customer complete and return to you the Certificate with respect to the particular

State(s) in which you are selling to them. On the Certificate, most of the State entries have numerical notations that refer to separate instructions that list conditions attached to use of the Certificate in that particular State. To access the Certificate and instructions you can go to www.mtc.gov. On the left, click "*Download the Uniform Sales and Use Tax Certificate*".

ii) Other States

If your customer is not in one of the States listed on the "Uniform Sales & Use Tax Certificate - Multijurisdiction" you must obtain the particular exemption form that is mandated by that State. Of course this will normally be available on the State's website.

2) You Purchase a Product

If you are a Canadian business that purchases a non-exempt product in the US, that is shipped to you in the US, (or directly to your customer in the US) the supplier may charge sales tax on the sale to you. However if you are re-selling the product you may be able claim an exemption from the tax. (But then you would be subject to the rules described in "*1. You Sell a Product*" above).

To claim the exemption from the supplier you would generally be required to register in the particular State where the product is delivered. Once registered you would then provide the supplier with one of the two documents mentioned above in "*1. You Sell a Product*"- i.e.

i) The Uniform Sales & Use Tax Certificate - Multijurisdiction, if it is applicable to your State, or

ii) The particular exemption form that is mandated by your State.

In this case, (and in the general case, where you are selling to an end user in the US) you must register in every State in which you will be exposed to State sales tax rules. This can potentially involve 51 jurisdictions, including the District of Columbia. Since this may involve a multitude of separate applications, fortunately there is a more efficient route if you choose to use it. Please see ***"THE STREAMLINED SALES TAX INITIATIVE".***

MORE ON EXPATRIATIONS

In the last Taxletter we mentioned some of the rules contained in the new expatriation rules, effective for expatriations after June 16, 2008. Please see Exhibit 1.

This new code section (877A) only applies to expatriations after June 16, 2008. The prior tax code section (IRC 877) remains in effect for expatriations prior to June 17, 2008.

The legislation enacted June 17th includes a new addition to the tax code defining "termination of United States citizenship" (see Code Section 7701(a)(50). This new section stipulates that a "long-term" resident of the US will be treated the same as a US citizen for these rules, and also addresses individuals who became dual citizens at birth.

Another change amends section 7701(b)(6) - i.e. the section defining US residency for income tax - by stating that an individual shall cease to be treated as a lawful permanent resident of the US if the individual commences to be treated as a resident of a foreign country under a tax treaty and does not waive the benefits thereof.

A further change indicates individuals who have annual requirements under the expatriation rule, and who fail to comply, will be subject to a $10,000 penalty. (IRC 6039G).

As indicated in the last Taxletter, new rules also apply after June 16, 2008, to certain gifts or bequests received by US citizens or US residents (including green card holders living in Canada). Please see Exhibit 2.

US SOCIAL SECURITY CONTRIBUTIONS & TAX CREDITS FOR CANADIAN RESIDENTS

Can Canadian residents offset Canadian income tax with all or part of their contributions made to US Social Security?

Paragraph 5 of CRA IT-122R2 originally stated that US social security taxes qualify as non-business income taxes for purposes of claiming a foreign tax credit in Canada. The Canada Revenue Agency (CRA) originally confirmed that German and French social security taxes also qualify. But CRA later revised its position. As a result of a Canadian court case it was determined that, to be a "tax", a levy must be imposed for a "public purpose". Since the payer derives an economic benefit from a contribution to social security, "the amount is not levied for a public purpose". Thus, as a general rule, social security payments to another country are not eligible for deduction as "foreign tax credits" on a Canadian income tax return.

EXHIBIT 1

Expatriation Rules Of Section 877A

Applicable Only To Individuals Who Expatriate After June 16, 2008

Are You An "Expatriate" - i.e:

Are You:
a) An Individual Who Relinquishes US Citizenship, (1) or
b) A "Long-Term Resident" Of The US Who: i) Surrenders A Green Card Or ii) Commences To Be Treated As A Resident Of A Foreign Country Under The Provisions Of A Tax Treaty? (2)

NO → The Expatriation Rules Do Not Apply To You

YES ↓

Are You A "Covered Expatriate" - i.e:

Have You Certified To The IRS Under Penalty Of Perjury That Your Tax Obligations For The Past 5 Years Have Been Met? (IRC 877A(g)(1)(A) and IRC 877(a)(2)(C)).

NO → You Are Subject To The "Mark To Market" Rule

YES ↓

<u>Tests</u>
1) Does Your Net Worth Exceed US $2 Million, or
2) For The Last 5 Years Has Your Average Annual US Income <u>Tax</u> Exceeded $124,000? (Adjusted For Inflation After 2004) (IRC 877A(g)(1)(A), 877(a)(2)(A) and (B))

NO → The Expatriation Rules Do Not Apply To You

YES ↓

You Are Subject To The "Mark To Market" Rule - i.e. Unless An Exception Applies You Are Deemed To Have Sold Your Worldwide Assets At Fair Market Value. In Computing Your Tax, An Exemption Applies For The First $600,000 In Deemed Capital Gains, (Adjusted For Inflation). (3)

(1) An Individual Is Considered To Relinguish US Citizenship (Expatriate) On The Earliest Of:
a) The Date The Individual Renounces US Nationally Before A Diplomatic Or Consualr Office,
b) The Date The Individual Furnishes To The US Department Of State A Signed Statement Of Voluntary Relinquishment Of US Nationally Confirming The Performance Of An Act Of Expatriation,
c) The Date Of Issuance Of A Certificate Of Loss Of Nationality By The US Department Of State, Or
d) The Date A US Court Cancels A Naturalized Citizen's Certificate of Naturalization. (IRC 877A(g)(4)).

(2) A Long-Term Resident Is An Individual (Other Than A US Citizen) Who Is A Lawful Permanent Resident Of The US (Holds A "Green Card") In At Least 8 Taxable Years During The Period Of 15 Years Ending With The Taxable Year Of Expatriation. (IRC 877(e)(2)).
An Individual Will Not Be Treated As A Lawful Permanent Resident For Any Taxable Year The Individual Is Treated As A Resident Of A Foreign Country For The Taxable Year Under The Provisions Of An Income Tax Treaty And Does Not Waive The Benefits Of The Treaty Applicable To Residents Of The Foreign Country.

A Long-Term Resident Is Considered To Expatriate On The Date The Individual Ceases To Be A Lawful Permanent Resident (IRC 877A(g)(3)(B), 7701(b)(6)).
An Individual Shall Cease To Be Treated As A Lawful Permanent Resident If The Individual Commences To Be Treated As A Resident Of A Foreign Country Under A Tax Treaty With That Country, Does Not Waive The Benefits Thereof, And Notifies The IRS Of Such Treatment. (IRC7701(b)(6)).

(3) Exceptions And Exclusions
a) Provided A Certain Maximum US Residency Period Is Not Exceeded. You Will Not Be Treated As Meeting The Requirements of IRC 877(a)(2)(A) or (B) If:
i) You Became At Birth A Citizen Of The US And Another Country, You Continue To Be A Citizen And Taxed As A Resident Of That Other Country, Or
ii) The Relinquishment Of US Citizenship Occurs Before Age 18 1/2.
b) Certain Items Are Excluded, Including Certain Deferred Compensation And Pension Plan Items, Certain Tax Deferred Accounts And An Interest In A Nongrantor Trust. (IRC877A(c)).
c) You May Be Entitled To Elect To Defer Payment Of The Tax Computed Under The Expatriation Rules, But Interest Will Be Charged. (IRC 877A(b)).
d) You Will Not Be Considered A Covered Expatriate For Any Period During Which You Are Subject To Tax As A US Citizen Or US Resident. (IRC 877A(g)(1)(C)).

Tax Code Section 877 (The Prior Tax Code Section Addressing Expatriations) Continues In Existence For Expatriations Prior To June 17, 2008, But Does Not Apply To Expatriations After June 16, 2008. (IRC 877(h)).

However, the CRA acknowledges that occasionally a Canadian may be temporarily working in another country and obligated to pay social security taxes in that country even though the individual will not be in the country long enough to actually qualify for the ultimate benefits. Therefore CRA will apparently accept contributions to a foreign public pension plan as a non-business income tax, eligible for a foreign tax credit, if the following two conditions apply:

1) The employee is compelled to make the contribution under the foreign country's legislation, and

2) It is reasonable to conclude the employee will not be eligible for benefits because his/her employment in the country is for a limited time.

(CRA Technical News TN-31R2, May, 2006).

This may be especially relevant for certain individuals working temporarily in the US while remaining a resident of Canada. If the individual is not sent to the US by his/her Canadian employer, the provisions in the Canada-US Social Security Totalization Agreement apparently do not exempt the individual from US social security tax. This tax, along with the US Medicare Tax, is generally much higher than Canada Pension Plan contributions.

Note also that Article II(2)(b)(iii) of the tax treaty states that the treaty applies to US Social Security taxes for purposes of Article XXIV of the treaty (Elimination of Double Taxation).

Please consult your Canadian tax advisor before taking any action.

EXHIBIT 2

Gifts And Bequests Received After June 16, 2008
By US Citizens Or US Residents From "Covered Expatriates"
(IRC 2801)

Are You A US Citizen Or US Resident? (1)

NO → The Gift And Bequest "Expatriation" Tax Rules Of Section 2801 Do Not Apply To You

YES ↓

Did You Receive A "Covered" Gift Or Bequest During The Year? (2)

NO → The Gift And Bequest "Expatriation" Tax Rules Of Section 2801 Do Not Apply To You

YES ↓

Unless An Exception Applies, You (The Recipient Of The Gift Or Bequest), Are Subject To US Tax Of 45% Of The Amount Of The Gift Or Bequest. (IRC 2801(a)).

Exceptions:
- a) Property Shown On A US Gift Tax Return Timely Filed By The Expatriate,
- b) Property Shown On A US Estate Tax Return Timely Filed By The Expatriate,
- c) Gift Tax Exclusions, Charitable Contributions, And Martial Deductions That Would Otherwise Apply Under Section 2055, 2056, 2522 And 2523, Will Still Apply.

Special Rules Apply To Gifts Made By A Domestic Trust, Or To A Foreign Trust. See IRC 2801(e)(4)).

(1) Also Includes Green Card Holders, And Other Individuals Who Meet The "Substantial Presence Test" And Do Not File A Valid IRS Form 8840.

(2) A "Covered Gift Or Bequest" Is:
- a) Any Property Received Directly Or Indirectly By Gift From An Individual Who, At The Time Of The Gift, Was A "Covered Expatriate", And
- b) Any Property Received Directly Or Indirectly By Reason Of The Death Of An Individual Who Was, At The Time Of Death A "Covered Expatriate".

For The Definition Of "Covered Expatriate" See Exhibit 1.

CANADA DETERMINED US DECEDENT'S PENSION PLAN FULLY TAXABLE IN CANADA

If a US citizen or domiciliary dies and leaves a US pension plan to an heir, the heir is generally subject to US income tax on the pension plan payments, but is able to deduct any US estate tax attributable to the pension plan. (IRC 691(c)).

For example, if you inherit a $100,000 pension plan and the US estate tax attributable to it is $40,000, then you are generally subject to US income tax only on the net $60,000. However if you are the heir, and a resident of Canada, what is your Canada income tax position on the $100,000 pension received?

Paragraph 1 of Article XVIII of the tax treaty states that a resident of Canada is not subject to Canadian tax on US pension payments to the extent the payment would be "excluded" from income in the US, if the recipient were a resident of the US.

Unfortunately CRA is of the view that "the fact that a US resident is entitled to claim a deduction for previous estate taxes paid in respect of amounts received out of (a US pension plan) does not result in the (pension) payment, or any part thereof, being "excluded" from taxable income in the US within the meaning of paragraph 1 of Article XVIII of the Convention". Therefore the entire $100,000 would be taxable in Canada. Of course a foreign tax credit might be available. A similar result occurs for payments from a US "IRA" pension.

CANADIAN BUSINESSES CHARGING US SUBSIDIARIES FOR SERVICES

Canadian businesses with US branches or subsidiaries are often faced with "transfer pricing" rules on cross-border intercompany transactions. Both Canada and the US have transfer pricing rules to restrict corporations from arbitrarily shifting profit from one country to another to obtain the lowest tax rate.

For example, the US may be concerned that the price charged by a Canadian parent to its US subsidiary for goods shipped from Canada to the subsidiary for resale in the US is too high, thus depriving the US subsidiary of taxable income. Similarly, the US may be concerned that administrative fees, or other services, charged by the Canadian parent to the US subsidiary may be unreasonably high, thus reducing the US taxable income.

The US rules for determining an acceptable price for an intercompany, cross-border services transaction can be complex and may generally require the engagement of a cross-border tax lawyer. However the US has issued somewhat simplified rules for a small subset of "controlled services transactions".

Charging for Specified Intercompany Services

The US tax regulations provide rules to "Determine Taxable Income In Connection With A Controlled Services Transaction" (Reg. 1.482-9T). The regulation describes seven separate acceptable alternatives, namely the:

1) Services cost method,
2) Comparable uncontrolled services price method,
3) Gross services margin method,
4) Cost of service plus, method,
5) Comparable profits method,
6) Profit split method, and
7) "Unspecified" methods.

Fortunately for many businesses, under the "services cost method" you can charge for services without imposing a mark up, provided you qualify. To qualify, your service must be a "*covered service*". Covered services are services which do not contribute significantly to fundamental risks of business success or failure. Therefore you must conclude the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure. (See Regs. 1.482-9T (b)(2) and (b)(4)).

You must meet three additional conditions to qualify for the "services cost method":

1) Maintain an adequate set of books and records,
2) Comply with the "intention standard" - i.e. generally to include in your books and records a statement that shows your intention to apply the services cost method to evaluate the arm's length charge for the services, and
3) Comply with the "adequacy standard" - i.e. generally to ensure your books and records are adequate to permit verification by the IRS of the total services costs incurred by the entity that is billing.

Also, under Reg. 1.482-9T(b)(4), to be a "covered service" the service must meet the definition of a "specified covered service" (e.g. see Revenue Procedure 2007-13) or a "low margin covered service" (Reg. 1.482-9T(b)(4)(ii)).

The regulations also list a number of transactions that may not qualify as a "covered service". (See Reg. 1.482-9T(b)(3)(ii)).

The rules are clearly very complex. Please consult your tax advisor before taking any action.

THE GROWING INTERNATIONAL TAX ISSUE OF "AGENCY"

For both US federal and individual US State taxation, the concept of "agency" is obtaining growing significance. Readers know that having an "agent" in the US can result in a Canadian business having unexpected US federal and/or State tax liabilities.

Under US federal tax law, there may be consequences if your Canadian business is considered to be "engaged in a trade or business in the US". Your Canadian business may be considered "engaged in a trade or business in the US" if your activities are "considerable, continuous and regular". (Pinchot, 113 F2nd, 719).

Whether or not your US activities are, in fact, "considerable, continuous and regular" may depend upon whether you have a US agent and whether that agent's activities are attributed to you. The US agent's activities will normally be attributed to you if the agent is a dependent agent. The agent's activities may, or may not, be attributed to you if the agent is an independent agent. An "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 F2nd 753; European, 11 TC 127).

An "independent agent" is generally 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.

If your Canadian business has an "agent" in the US, there may be a significant difference in the US tax consequences depending upon whether the agent is a dependent agent or an independent agent.

SOME FEDERAL TAX CONSIDERATIONS

The difference between a dependent agent and an independent agent may depend on the tax issue you are addressing. There are different "agency" rules, depending on whether you are attempting to evaluate if your Canadian business:

a) Is "engaged in a trade or business in the US", and thus required to file a US income tax return,

b) Will have the office of the US agent attributed to your business, and thus potentially subject you to US income tax on non-US income, or

c) Will be considered to have a US "permanent establishment", for treaty purposes.

Please see Exhibit 3.

For a brief comment on "agency" as it relates to US individual State tax matters please see ***"THE GROWING INTERNATIONAL TAX ISSUE OF "AGENCY" - SOME STATE CONSIDERATIONS"***

Dependent v. Independent Agent

"Business Status" Evaluation. Evaluating whether your Canadian business is "engaged in a trade or business in the US" is important because it determines whether you are required to file a US federal income tax return. In making this determination you must consider what activities are attributed to you as a result of the activities of your US agent. In making this evaluation, it may depend on whether your agent is a dependent agent or independent agent. Apparently a decisive element in distinguishing between the two is the degree of control exercised by the principal. (See Lewenhaupt, 20 TC 151). Thus an employee would normally tend to be a dependent agent.

The activities of other persons subject to a high degree of control by the taxpayer, such as agents acting exclusively or almost exclusively for the taxpayer will likely be imputed to the taxpayer. (Revenue Ruling 70-424). However if the activities of the agent are merely "ministerial", and not related to the profit-making activity, for example if a US agent only receives payments from customers and remits them to a Canadian head office, there may be insufficient activity by the agent to cause the Canadian business to be engaged in US business. (Scottish American Investment Company, 12 TC 49, and Spermacet Whaling and Shipping Company, 30 TC 618).

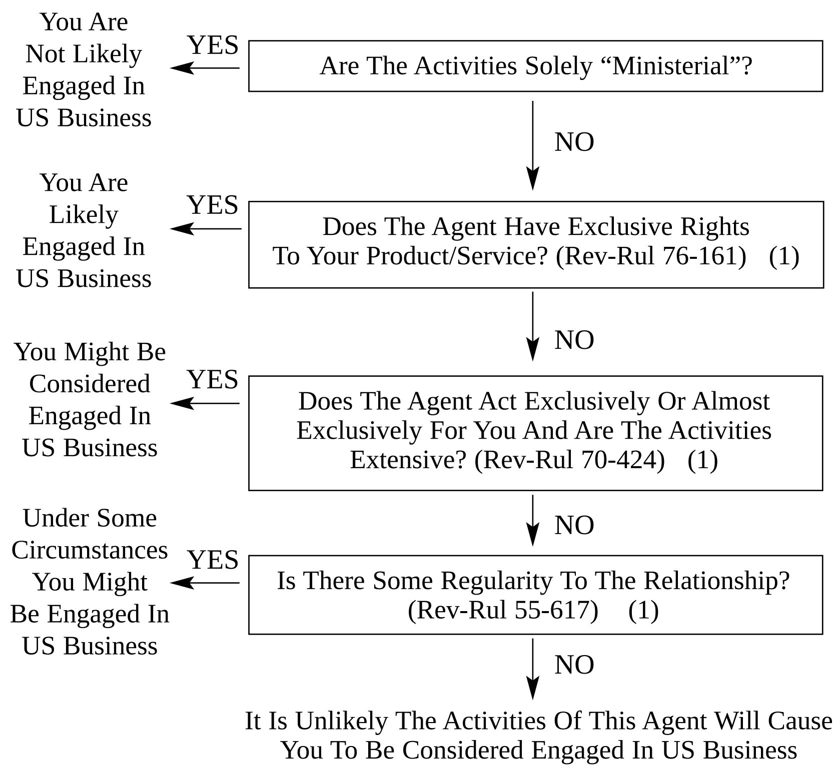
If a US agent has the "exclusive rights" to sell products of a foreign business and they are sold from that agent's US warehouse, the

EXHIBIT 3

Some Tax Code (Not Treaty) Rules For Attributions From Agents For US Federal Tax Purposes

Determining Whether You Are Considered Engaged In US Business
"Business Status Evaluation"

(Rules Applicable To The Activities Of An Otherwise "Independent" Agent)

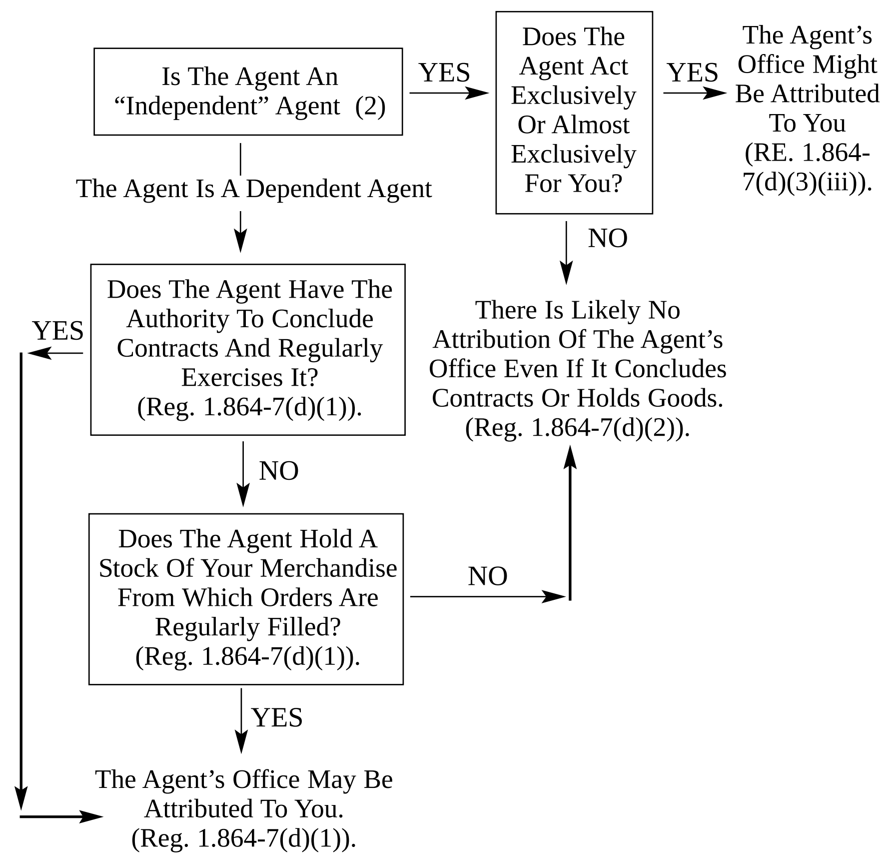


(1) Does Not Apply To A Seller/Purchaser Relationship.

(2) I.e. Is The Agent A Broker, General Commission Agent, Or Other Agent Of Independent Status Acting In The Normal Course Of His Business In That Capacity. The Agent May Still Be Independent Even If It Holds Goods On Consignment. (Reg. 1.864-7(d)(3)).

Determining Whether You Have An Office Or Other Fixed Place Of Business
For Internal Revenue Code (Not Treaty Purposes)

(Rules Applicable To Dependent And Independent Agents)



agents' US activities may be attributed to the foreign business if the agent is paid by way of commission. (Rev-Rul 76-161). However if the foreign person sells the goods to the US person for independent resale the US person/purchaser is likely not an agent.

In one case, a person was treated as engaged in US business because of the purchase and management of real estate by independent real estate agents on his behalf. (de Amodio v. Commissioner, 34 T.C. 894, 906, 909 and Investors Mortgage Security Co. v. Commissioner, 4 T.C.M. 45). In another case, substantial sales through a US distributor on behalf of a foreign person were attributed to the foreign person. (Handfield v. Commissioner 23 T.C 633).

A broker or commission agent may be an independent agent where it has little control of the underlying activity (even though the underlying activity may be a trade or business). An agent who is otherwise independent, but whose activities are extensive and solely on behalf of a single entity may result in the agent being considered a dependent agent.

Also, apparently the activity of a "independent agent" might be attributed to the principal if there is some regularity to the relationship. (See Revenue Ruling 55-617 and Handfield, 23TC 633). On the other hand, the activities of such an agent might not be attributed to the principal if the agent does not have the right to commit to any particular customer. (Piedras Negras Broadcasting, 43 BTA 297).

The following activities may not necessarily cause you to be engaged in US business:

1) The purchasing of products in the US for resale outside the US if you have no US office,

2) Advertising and promotion in the US, provided there is no active solicitation of orders in the US,

3) The direct sales of your product to US customers provided you have:

a) No US office, employees or agents,

b) No marketing or direct solicitation activity in the US, and

c) No inventory in the US.

"Office or Place of Business" Evaluation. A determination of whether a Canadian business is considered to have "an office or other fixed place of business in the US" can be significant because it may determine whether non-US source income (for example sales to your Canadian customers) will, in unusual circumstances, be treated as effectively connected with your US trade or business and thus taxable in the US. (IRC 864(c)(4)(B)).

Separate regulations defining whether a foreign business has an office or place of business in the US (i.e. not defining "business status") provide guidelines for determining whether an agent is an "independent agent". Generally, for this purpose, an "independent agent" means a general commission agent, broker, or other agent of independent status acting in the ordinary course of its business in that capacity. (Reg. 1.864-7(d)(3)(i)).

The office of an independent agent would generally not be attributed to the foreign business. But if an otherwise independent agent acts exclusively, or almost exclusively for one foreign business the facts and circumstances should be taken into account in determining whether or not the agent is independent. (Reg. 1.864-7(d)(3)(ii).

An otherwise independent agent who, in pursuit of his usual trade of business, sells goods consigned to him may still be an independent agent. (Reg. 1.864-7(d)(3)(i)), and 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)).

The office of a dependent agent will not be attributed to a foreign business unless:

1) The agent has the authority to negotiate and conclude contracts in the name of the foreign business, and regularly exercise that authority, or

2) The agent holds a stock of merchandise belonging to the foreign business from which orders are regularly filled on behalf of the foreign business.(Reg. 1.864-7(d)(1)).

Permanent Establishment (PE). Readers know that Article V of the tax treaty states "*a person acting in a Contracting State on behalf of a resident of the other Contracting State -- other than an agent of independent status to which paragraph 7 applies -- shall be deemed to be a permanent establishment in the first mention state if such person has, and habitually exercises in that State, an authority to conclude contracts in the name of the resident of the other state*".

Paragraph 7 of Article V of the treaty states "*A resident of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in that other State through a broker,* *general commission agent or any other agent of independent status, provided that such persons are acting in the ordinary course of their business".*

(Recall that paragraph 9 of Article V, added by the 5th Protocol, provides new rules for when a PE is created because of services performed in a country).

As a result of all the foregoing, more than one possibility arises. For example:

1) Your Canadian business has sales in the US (and perhaps and "independent" agent in the US) but, in your tax advisor's opinion, the activity does not rise to the level of being "engaged in a trade or business in the US". In this case you may wish to file a simple "protective" US income tax return.

2) Your Canadian business is "engaged in a trade or business in the US" but does not have a US "permanent establishment". In this case you must file a US federal income tax return but there may be no US federal tax.

3) Your Canadian business is "engaged in a trade or business in the US" and has a US "permanent establishment". Of course in this case a federal income tax return is required and there may be a federal income tax liability.

4) Your Canadian business is "engaged in a trade or business in the US", has a US "permanent establishment", and also has an "office or fixed place of business in the US" attributed to it by a US agent. In this case a federal income tax return is required and income received from sources in Canada and other places outside the US may be required to be reported on the US income tax return if they can be considered attributable to the US office.

THE GROWING INTERNATIONAL TAX ISSUE OF "AGENCY" - SOME STATE CONSIDERATIONS

Readers know a Canadian business may have tax obligations in an individual US State if the business has "nexus" in that State. Federal Constitutional matters applicable to State taxation are:

1) The Commerce Clause of the U.S. Constitution (the applicable part is codified in the "Interstate Income Law", PL 86-272 (15 USC 381), and

2) The Due Process Clause of the U.S. Constitution. Some important federal court cases applicable to State taxation are:

1) Complete Auto Transit, 430 US 274, (nexus),

2) Mobil and Oil, 445 US 425, and Exxon, 447 US 207, (nexus),

3) Miller, 347 US 340 with respect to the Due Process clause, (nexus),

4) Quill Corp 504 US 298., (physical presence and sales tax), and

5) Scripto, 362 US 207 (sales tax and independent contractors).

For some applicable constitutional, legislative and judicial issues please see Exhibit 4. For some comparisons of "nexus" for income tax, sales tax, and franchise tax purposes, please see Exhibit 5.

As a result of the "Complete Auto Transit" case, before a State can levy tax, there must be a "substantial nexus" within the State, the tax must be fairly apportioned, it must not discriminate against interstate commerce, and it must be fairly related to the services provided.

Under Mobil, Exxon, and Miller, the Commerce Clause and the Due Process clause prohibit State taxation of interstate activities unless there is a minimal connection or "nexus" between such activities and the taxing state and a "rational relationship between the income attributed to the State and the intrastate values of the enterprise".

State Income Tax

If your business has "nexus" in a particular State you can be subject to State income tax in that State.

Tangible Personal Property Exception. As a result of the Interstate Income Law (P.L. 86-272) individual States are barred from levying income tax on the sale of tangible personal property if the only business activity in the State is the solicitation of orders for the sale of tangible personal property and the orders are approved and filled outside the state.

Other income. However other income is subject to State income tax if there is sufficient "nexus" in the State. The US Supreme Court has not addressed whether "physical presence" in a given state is required in order to have nexus in that State for purposes of income tax. Please see Exhibit 5 that summarizes some prior developments. A State will often assert nexus if property is owned or used in the State.

Agents and Nexus. In addition to circumstances where the existence of nexus is clear, or at least arguable, the States are apparently also adopting a concept called "attributional nexus" under which they would assert that an entity has nexus in the State because the entity has some sort of relationship with another entity already subject to tax in that State. - i.e. they may assert that the entity has an agency relationship with another entity that does have direct nexus in the State. Many surprising assertions of nexus have arisen from this concept.

In one case, Amway Corporation was subject to State income tax in Missouri even though it had no employees or property in Missouri. A State court determined that the Missouri-based distributors of Amway that were soliciting the sale of distributorships were agents for the purpose of soliciting sales even though they were not employees and did not have the legal authority to enter into contracts on behalf of Amway. (Amway v. Missouri Department of Revenue, 794 SW 2nd 666).

State Sales Tax

As a result of the Quill Corp case, an out-of-State business must have "a physical presence" in a State before State sales tax can be levied on the out-of-State seller.

The State Government Tax Agencies and State Courts have many different views on the level of activity or circumstances that satisfy the "physical presence" requirement - i.e. that create nexus. Some States only impose sales tax when the out-of-State taxpayer is present in the State on a systematic, regular basis. However other states may argue there is nexus when the taxpayer is there only sporadically.

Agents and Nexus. In the Scripto case (Scripto 362 US 207) the US Supreme Court agreed that Florida could levy use tax on an out-of-State corporation that did not have an office or other facility in Florida, did not have any employees or dependent agents in Florida and did not own or maintain a bank account or stock of merchandise Florida. Its orders for products were solicited by advertising specialty brokers (wholesalers or jobbers - i.e. independent contractors) who were residents of Florida. It did not matter that any agent worked for several principals.

Apart from the circumstances where "physical presence" is obvious, or at least arguable, a State might assert the "attributional nexus" concept . Generally, online sales may be subject to State sales tax if they can be returned to a "bricks and mortar" affiliate within the State. In furtherance of this concept some States have enacted "nexus-by-affiliation" statutes. Under this principle, nexus exists if the seller has membership in an affiliated group, at least one other member of which has nexus with the State.

Franchise/Excise Tax

Restricted in its ability to levy income tax in many cases because of the Commerce Clause, and restricted in its ability to levy sales tax because of the "physical presence" requirement, many States have implemented a tax known variously as franchise tax, excise tax, business activity tax (BAT), etc. This tax (for the privilege of doing business in the State) is often based on a proportional allocation of the taxpayers equity to the State.

EXHIBIT 4

Some Federal Constitutional, Legislative, And Judicial Provisions Relevant To State "Nexus"

US Constitutional Provisions	*Applicable Federal Legislative Provision*	*Some Applicable Federal Cases*
The "Commence Clause" Of The US Constitution (Article 1, Cl 3), Reserves To Congress The Right To Regulate Commerce Among The States. The "Due Process Clause" (14th Amendment) Prevents A State From Depriving Any Person Of Life, Liberty, Or Property, Without Due Process Of Law.	The Interstate Income Law (P.L. 86-272, 15 U.S.C. 381) Governs Only State Income Tax On The Sale Of Tangible Personal Property. There Is No Other Applicable Federal Legislation Related To Income Tax, Sales Tax Or Franchise / Excise / "Business Activity" Tax.	Mobil Oil, 445 US 425, 407, 100 SCt 1223, And Exxon, 447 US 207, 100 SCt 2109. "Both The Commerce And The Due Process Clauses Prohibit State Taxation Of Interstate Activities Unless There Is A Minimal Connection Or Nexus Between Such Activities, And The Taxing State And A "Rational Relationship Between The Income Attributed To The State And The Intrastate Values Of The Enterprise". Quill Corp (504 US 298) Requires "Physical Presence" In A State Before Sales Tax Can Be Levied.

EXHIBIT 5

Some Nexus Comparisons For Income Tax, Sales Tax, And Franchise Tax

State Sales Tax

State Income Tax

Special "Nexus" Rule For Sale Of Tangible Property - Federal Law (PL 86-272) Bars States From Levying Income Tax On The Sale Of Tangible Personal Property If The Only Business Activity Is The Solicitation Of Orders For The Sale Of Tangible Personal Property And The Orders Are Approved And Filled Outside The State. A Person Will Not Be Considered Engaged In Business In The State Merely By Reason Of Sales Or Solicitation Of Sales In The State Of Tangible Personal Property By Independent Contractors, Or Due To The Maintenance Of An Office In The State By Independent Contractors Whose Activities On Behalf Of The Person Consist Of Making Sales Or Soliciting Orders For Tangible Personal Property.

There Are No Specific Provisions In Federal Law With Respect To Other Products Or Services.

Apart From The Above Tax Exemption For Tangible Personal Property, It Is Uncertain (Under Federal Law), Whether "Physical Presence" Is Required To Establish Nexus. The US Supreme Court Has Declined To Address The Issue (A&F Trademark, Inc. v. Tolson, Petition For Certiorari Denied Oct. 2005).
- However Various States Have Made Rulings - For Example
- Physical Presence Is Not Required In Ohio (Ohio Dept. Of Taxation CAT Information Release CT 2005-2).
- Physical Presence Was Not Required In West Virginia For An Out-Of-State Bank That Generated Substantial Credit Card Fees In West Virginia And Received Substantial State Benefits Such As Protection Of Banking Laws And Access To Courts. (Steager MBNA America Bank, W. Virginia Court, No. 04-AA-157).
- New Jersey Has Decided Physical Presence Is Not Required. (Lanco, NJ Supreme Court, A-89-05. Oct 2005).
- South Carolina Has Decided That Nexus For Income Tax Will Be Determined Without Regard To Whether The Business Owns Or Utilizes A Distribution Facility Within The State. (H.B. 3006, Laws 2005).
- New Mexico Determined An Out-Of-State Manufacturer Of Tupperware Products That Entered Into A Franchise Agreement With A New Mexico Distributor Was Not Protected By PL 86-272 And Was Subject To New Mexico Corporate Income Tax Because Its Business Activities In The State Were Not Limited To The "Solicitation Of Orders". The Distributor Only Handled Orders For That One Principle. (Dart Industries, NM Taxation And Rev Dept. - No. 04-03, Feb. 2004)
- New York Determined That An Out-Of-State Corporation That Rented Office Space In NY For The Convenience Of Its President Created Nexus.
- Massachusetts Decided An Out-Of-State Corporation Had Nexus In Massachusetts Because It Was A Limited Partner In A Massachusetts Business. (Utelcom, MA Appeliate Board No. C262339, Jan. 2005).
- Virginia Determined That Warranty Services Carried On In Virginia By An Independent Contractor On Behalf Of An Out-Of-State Taxpayer Was The Purchase Of Services By The Taxpayer That Were Then Resold To The Taxpayer's Customers And Therefore Did Not Create Nexus For The Taxpayer. (Virginia Dept. Of Taxation Public Document (P.D.) 99-278 (1999). Virginia Reached A Similar Conclusion In P.D. 01-136 (2001) With Respect To An Out-Of-State Sign Manufacturer Whose Repair Service In Virginia Were Provided By Independent Contractors.
- Missouri Held Amway Subject To Income Tax Even Though It Had No Employees Or Property In Missouri. A State Court Held The Missouri-Based Distributors For Amway That Were Soliciting The Sales Of Distributorships Were Agents For The Purpose Of Soliciting Sales Even Though They Were Not Employees And Did Not Have The Legal Authority To Enter Into Contracts On Behalf Of Amway. (Amway v. Missouri Dept. Of Revenue, 794 SW 2nd. 666).

State Sales Tax

There Is No Provision In Federal Statutory Law. However, Under Quill Corp. (504 U.S. 298) Physical Presence In A State Is Required In Order For The State To Levy Sales Tax. But "Physical Presence" Likely Includes Having Sales Representatives, Employees, Or Independent Contractors Soliciting Sales Even If They Have No Authority To Conclude Contracts.

California Decided An Out-Of-State On-Line Retailer Had Nexus In California And Was Subject To California Sales Tax Because Its "Bricks And Mortar" Affiliate Acted As Agent When It Accepted Returns Of Goods Ordered On-Line. (Borders CA Court Of Appeal, First Appellate District No. A105488, May 2005).

Pennsylvania, California And Other States Consider That Participation In A Trade Show As An Exhibitor Creates Nexus (Physical Presence) For Sales Tax. Each State Has "De Minimus" Rules For Trade Show Exemptions.

The Missouri Department Of Revenue Has Ruled The Sales Of Downloadable Copyrighted Photographs Over The Internet By A Website-Based Business Are Not Subject To Missouri Sales Tax If There Is Not A Transfer Of Tangible Property Involved. (Missouri Letter Ruling LR 5058, August, 2008).

An Out-Of-State Vendor Has Nexus In California For Sales Tax If It Has A "Salesperson" Engaged In Authorized Selling Activities On Behalf Of It. A Link On The Seller's Affiliate's Website May Not Suffice To Establish That The Seller Is An "Authorized Salesperson" Unless The Affiliate Engages In Promoting The Link.

With Regard To Sales Activities By Independent Contractors See Scripto, Inc. v. Carson 362 U.S. 207 (1960). The US Supreme Court Held That An Out-Of-State Corporation Had Nexus In Florida For Use Tax Because Of The Solicitation Of Orders By Independent Contractors In Florida.

With Regard To Post-Sale Services. Provided By Independent Contractors See, For Example. Virginia Department Of Taxation Public Document 99-278 And 01-136 Under "State Income Tax" Which *Might* Be Relevant.

State Franchise/Excise "Business Activity" (BAT) Tax

There Is No Provision In Federal Statutory Law.
It Is Uncertain Whether "Physical Presence" Is Required.
(See Comments Under State Income Tax).
However Various States Have Made Rulings - For Example
- Physical Presence Is Not Required In New Jersey (Lanco NJ Supreme Court A-89-02. Oct. 2006).
- Physical Presence Is Not Required In Ohio (Ohio Dept. Of Taxation CAT Information Release CT 2005-2).
- Michigan Decided An Independent Contractor Soliciting Sales In Michigan Constituted "Presence" For Its Business Activity (SBT) Tax. (Hobbs Michigan Court Of Appeals, No. 254069, Sept. 2005).
- Texas Decided An Out-Of-State Corporation That Provided Investment Services, Business Consulting, And Bookkeeping Services To Clients In Texas Had Nexus. The Performance Of Any Service In Texas Apparently Creates Nexus. Controller Of Public Accounts Letter No. 200408773L, Aug. 2004).
- Ohio Has Issued A "Bright Line" Presence Test Based On Quantitative Data (Sec. 5751.01(1) Ohio R.C.).
- Pennsylvania Confirmed A Corporation That Merely Solicits In Pennsylvania Is Subject To The Franchise Tax (Quality Markets).
- Having Property In A State Usually Constitutes Nexus For Franchise Tax.

(See Also All Determinations Listed Under "State Income Tax". Since The Threshold For Nexus For Franchise Tax May Be Lower Than The Threshold For Income Tax, It Is Likely Any State's Determination Of Nexus For Income Tax Would Also Apply For Franchise Tax. Thus Where A Business Is Exempt Income Tax Due To The "Commerce Clause", It May Still Be Subject To The State's Franchise Tax.)

This tax appears to have the lowest threshold of all for determining whether nexus exists. Thus, having extremely minimal presence in a State (for example in one particular State a one-time visit by a sales representative) may constitute nexus. Thus it is highly likely the regular use of independent contractors in a State will create nexus for this purpose regardless of whether they have authority to conclude contracts.

A State will often assert nexus if there is property owned or used in the State.

US CITIZENS & GREEN CARD HOLDERS - BEWARE TRANSFERS TO CANADIAN TRUSTS

If you are a US person you may have a taxable gain for US purposes if you transfer property to a Canadian (or other non-US) trust or estate. (IRC 684). Please see the exceptions below. A US person is a US citizen or resident, a domestic (US) corporation, trust, partnership or estate. It also includes a nonresident alien who either meets the substantial presence test and does not file IRS Form 8840, or who has elected to file a joint US income tax return.

Thus, for example, the transfer of appreciated securities to a Canadian trust by a green card holder living in Canada may trigger taxable gain in the US. (This may occur even if the gain is solely the result of appreciation in the Canadian dollar against the US dollar).

The same result may arise if:

i) After December 31, 2009, there is a transfer to a nonresident alien, unless it is a "lifetime" transfer (IRC 684(b)(2), (see sunset provision), or

ii) A domestic (US) trust becomes a foreign trust.

Exceptions

Among other exceptions, the taxable gain described above does not apply:

i) To the extent a US person is treated as the "owner" of the foreign trust under Code Section 671,

ii) To transfers to certain charitable trusts, or

iii) To certain transfers at death.

(See Reg. 1.684-3).

Also please see the article "***REVISITING FORM 3520 AND TRUSTS***".

THE STREAMLINED SALES TAX INITIATIVE

Partly as a result of the confusion over sales tax rules, and the competition between States to obtain this revenue, certain individual States joined to form the "Streamlined Sales Tax Project" to attempt to reduce the confusion, administrative work, and expense, that businesses incur administering State and local sales tax laws.

Part of their efforts include "standardizing definitions, utilizing common forms and procedures, the certification of sales tax administration software, and the use of its website to allow businesses to register for sales tax collection purposes".

Businesses are invited to register with the Streamlined Sales Tax Project ("SSTP"). If you register (become a "participant") in the SSTP you will automatically be registered for sales tax in all the SSTP member States, thus eliminating the need to register separately in each of those States.

However you cannot pick and choose. If you register with the SSTP, you register for sales tax in all States that participate in SSTP. (Of course this does not mean that you are liable for sales tax in a State in which you have no sales, or if your product or service is not taxable.) Please go to www.streamlined-salestax.org. About 22 States are participants, but the list is constantly changing (generally increasing).

An important tool provided by the SSTP is the "Taxability Matrix". This document is available on the website of each State that is a member of the SSTP. Among other things the "Taxability Matrix" lists a multitude of products and services, setting out whether the item is taxable or exempt, and often setting out the particular State tax statute involved.

Another helpful tool provided by the SSTP is the certification of sales tax software which can help you sort out and determine the amount of sales tax payable in the various States and Counties in which you are liable for the tax.

A further benefit of membership in the SSTP may be the grant of amnesty on prior unreported sales tax liabilities.

DEDUCTING EXPENSES ON REAL ESTATE SALES

We previously summarized special rules for deducting certain expenses when a non-resident alien or foreign corporation sells US real estate. Although the rules were issued by the IRS in Chief Counsel Advice (CCA) 200504029, we recently experienced an IRS temporary disallowance of the deduction for these expenses.

CCA 200504029 provides that "*because (real estate gain) is treated as effectively connected income, expenses otherwise deductible that are connected to effectively connected income are permitted to be deducted by the taxpayer. For example, real estate taxes, interest, maintenance and repairs, and insurance expenses incurred with respect to the real estate, would be deductible for the taxable year the (real estate gain) was recognized*".

After an IRS individual rejected our claim for the deduction, we referred the IRS person to CCA 200504029 above. The issue then became whether (in the case of an individual) the deduction should be claimed on page 1 of the tax return in the section for "effectively connected income". The IRS person claimed that the amount should be claimed on Schedule A on page 2 of the return (itemized deductions).

In any event, as a separate matter, recall that expenses might only be deductible if they are claimed on a "timely filed" return. Please see the Winter-Spring, 2008 issue of the Taxletter.

NO CANADIAN TAX DEDUCTION FOR US TAX CAPITAL GAINS TAX - A SPECIAL CASE!

If a resident of Canada incurs US "capital gains tax", there is, of course, a potential foreign tax credit available on the Canadian income tax return, provided there is appropriate non-Canadian income to report on the Canadian income tax return.

However suppose there is no "non-Canadian" (foreign) income to report on the Canadian income tax return. For example, there is no foreign income to report because:

1) Due to the decline in the US dollar, a real estate gain in the United States does not result in a gain for a Canadian purposes, or

2) The Canadian individual taxpayer elects (and is eligible) to claim the sale of a US residence as a principal residence for Canadian tax purposes, or

3) The Canadian individual taxpayer acquired the US asset while a resident of the US, and later moved to Canada and obtained a "step up" in cost base in the particular asset equal to, or higher than, the current selling price.

Since there is no "foreign source income" there is no foreign tax credit available on the Canadian return.

The deductions under ITA sections 20(11) and 20)12) are not available on the Canadian return because those sections provide that the deduction is available in computing the taxpayers "income". Since the ITA section 3 definition of "income" excludes "capital gains", a deduction under 20(11) or 20(12) is apparently not available.

FORECLOSING ON THE BUYER OF YOUR US REAL ESTATE

In general, if you modify the terms of a "debt instrument" owed to you it can trigger a deemed sale of the instrument. This could result in a taxable gain or loss to you.

However special rules apply to foreclosures of real estate.

Foreclosures In General

In general, if you sell real estate, take back a mortgage, and ultimately reacquire the property as a result of foreclosure, there will be no taxable gain or loss to you on the reacquisition of the property, even if the property is worth more than the amount owed to you. (IRC 1038). (But see ***"Modification of Installment Obligations"*** below).

Partial exceptions to the "no gain" rule may apply if;

1) You received money or property prior to the foreclosure in excess of the gain previously reported on the sale, or

2) You receive money or property in connection with the foreclosure.

Also, special rules apply if you are reacquiring property on which you previously excluded gain under the "principal residence" rule.

(For foreclosures on property other than real estate, the rules of section 166 apply).

Modification of Installment Obligations

A separate rule applies to an "installment obligation" - i.e. the sale of property in which you take back a mortgage and report your gain proportionately as cash is received from the buyer. This "proportionate" reporting is the default rule for gain that applies unless you elect otherwise. Thus, if you are a resident of Canada and are not reporting the gain on the "installment method" in Canada, consideration must be given to specifically "electing out" of installment reporting on the US tax return, in order to ensure efficient use of foreign tax credits.

If you "dispose" of an installment obligation, in general all the unreported gain immediately becomes taxable. (IRC 453B). A change in the installment obligation can potentially be considered a disposition. However exceptions apply in the case of "business-motivated" changes, such as:

i) A renegotiated sales price,
ii) An increased interest rate,
iii) An extended maturity, and certain other situations.

See Revenue Rulings 55-429, 68-419, and 72-570.

REVISITING FORM 3520 AND TRUSTS

Readers are aware that US citizens and US residents (including green card holders living in Canada) must file IRS Form 3520 annually with respect to their involvement in certain foreign (non-US) trusts. The annual penalty for noncompliance is 5% the value of their portion of the trust, and 35% of the amount of the distribution received.

Are you required to file Form 3520 to report your ownership of a Canadian mutual fund that is organized as a trust? If Form 3520 applies, it would even apply to mutual funds held inside RRSPs and RRIFs.

Treasury Reg. 301.7701-1(a)(1) states that "the Internal Revenue Code pre-scribes the classification of various organizations for federal tax purposes". Reg. 301.7701-4 addresses/defines (among others):

1) Ordinary trusts,
2) Business trusts, and
3) Certain "investment trusts".

Ordinary Trusts

According to the regulations, "*the term "trust" refers to an arrangement…… whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries…….. Generally speaking, an arrangement will be treated as a trust… if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for the beneficiaries who cannot share in the discharge of this responsibility…..*".

Business Trusts

According to the regulations, "*there are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts…………… because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts……. which are generally a device to carry on a profit-making business….. are classified as corporations or partnerships under the Internal Revenue Code*".

Thus, if a Canadian income trust or mutual fund trust is a device to carry on a profit-making business, it may not be treated as a trust for US income tax purposes. (Instead it may be treated as a corporation).

Certain "Investment Trusts"

According to the regulations, an "investment trust" will not be classified as a trust if there is a power under the trust agreement to vary the investments of the certificate holders". The regulations set out four examples attempting to clarify the definition of an "investment trust".

Therefore if a Canadian mutual fund trust contains a power under the trust agreement to vary the investments of the certificate holders it might be treated as a corporation rather than a trust, for US income tax.

A 1941 US court case ruled that "a power to vary the investment of the certificate holders exists if there is a managerial power under the trust instrument that enables a trust to take advantage of market variations to improve the investment of the investors". The court also held that a power to acquire new (bonds) upon the addition of new investors, where existing investors would acquire a pro rata interest in the new (bonds) was a power to vary the investment of the existing investors. (Commissioner v. North American Bond Trust, 122 F.2d 545).

In Revenue Ruling 78-149, the IRS concluded that "the right to replace bonds called by the issuer prior to maturity with other similar bonds is a power to vary.

For other guidance, please see PLRs 200752029, 200810002, and 200810010.

We have discussed this with IRS tax lawyers in Washington and have not been able to obtain even an informal comment or opinion regarding the status, in general, of non-US mutual funds that are trusts. Part of the reluctance may be the fact that the case history and the prior IRS guidance, has been based on the specific facts and the specific terms of the particular trust document which was the subject of the court case or IRS guidance involved.

Although it appears many Canadian mutual fund trusts may be corporations for US purposes, tax practitioners may feel the need to review the actual trust documents for any such mutual fund before offering an opinion with respect to that mutual fund.

Unfortunately, if the Canadian mutual fund trust is determined to be a corporation for US income tax purposes, it might then be classified as a "passive foreign investment corporation" (PFIC). We previously described the potentially "unpleasant" US tax consequences of owning a PFIC.

CURRENCY TRANSLATIONS

If you are a "US person" you may be required to use special US tax rules for currency translations if you have:

1) A US Corporation with a non-US branch,

2) A Foreign (non-US) corporation with a foreign branch,

3) A "Section 988" transaction,

4) Personal (non-corporate) transactions that are "business" transactions but not Section 988 transactions.

Before applying the US tax code's currency translation rules to your circumstances it is necessary to first determine your "functional" currency". We briefly described some rules for determining your "functional currency" in the Winter/Spring, 2007, Taxletter.

A US Corporation with a Non-US branch

A US Corporation with branch operations outside the US constituting a "qualified business unit" must first compute the branch's profit or loss from operations in the branch's "functional" currency. (IRC 987). If this is not the US dollar, the taxable income is then translated at "the appropriate exchange rate" as provided in section 989(b)(4) and described in the Winter/Spring, 2007, Taxletter.

When remittances are made to the home office, exchange gain or loss is recognized to the extent, in general, that the value of the foreign functional currency relative to the US dollar when remitted, differs from the value when earned. (IRC 987(3)). Exchange gains or losses attributable to the remittances are characterized as ordinary income or loss.

These rules also apply to a sole proprietorship provided there is a "qualified business unit" using a functional currency other than the US dollar.

A Foreign (non-US) Corporation with a Foreign Branch

A foreign corporation with a functional currency other than the US dollar determines its profit or loss (and earnings and profits) in its functional currency. Unrealized exchange gains and losses resulting from balance sheet currency translations are not taken into account in the income statement.

Dividends. For actual distributions of earnings and profits, the distribution is translated into US dollars using the spot rate at the date of the distribution. (IRC 989 (b)(1) and (2)).

Section 951/Subpart F Inclusions. The subpart F regulations contain two different sets of rules - one for section 988 transactions and one for non-988 transactions. We described the nature of a section 988 transaction in the Winter/Spring, 2004, Taxletter.

1) As to gains from Section 988 transactions, "foreign personal holding income" includes the excess of foreign currency gains over losses, but section 954(c)(1)(D) excepts from such treatment any transaction directly related to the "business needs" of the corporation. There is also an exception for "active" business gains and losses. (IRC 954(c)(1)(C))

2) Items that are not within section 988(a)(2) or (d) relating to debt instruments and forward contracts, are not considered currency gain or loss for purposes of foreign personal holding income. But the gain may be some other category of foreign personal holding income.

Income inclusions under subpart F are translated into US dollars using the average rate for the year. (IRC 989(b)(3)).

Earnings and Profits. The corporation's "earnings and profits" are first determined in the corporation's functional currency and then translated into US dollars using the appropriate exchange rate (generally the average rate). For actual distributions, earnings and profits determined in the functional currency are translated under section 989(b)(1) into US dollars using the spot rate in effect on the date of the distribution.

Distributions of Previously Taxed Income. If income which has been previously taxed under section 951, including the subpart F rules, is distributed, the exchange gain or loss attributable to movements in exchange rate between the date the earnings are included using the average rate, and the date they are actually distributed, are treated as ordinary income or loss to the shareholder.

Transactions in a Non-Functional Currency. A foreign corporation may operate in different countries and have transactions in a non-functional currency. The issue may then become how to compute the corporations Subpart F income and/or its earnings and profits if the corporation has one or more branches with a functional currency different than that of the foreign corporation itself. Please see Reg. 1.985-1(d) (2).

Section 988 Transactions

A section 988 transaction only occurs when a taxpayer has a business or investment transaction in a non-functional currency. Thus it does not apply, for example, in the case of:

1) A US corporation having a transaction in its non-US dollar "functional currency" in its foreign branch, or

2) A foreign corporation having a transaction in its non-US dollar "functional currency", or

3) A US citizen or resident, with a functional currency of the US dollar, having a non-US dollar transaction that is strictly personal and not business or investment related.

A common section 988 transaction may occur when a US citizen/US resident (or a US corporation using the US dollar as its functional currency) has a business or investment transaction in a currency other than the US dollar. For example, a US citizen living in Canada may buy and sell Canadian dollar denominated securities.

Another example may occur when a US citizen/US resident (or US corporation using the US dollar as its functional currency) uses the accrual accounting system and has a business transaction involving accounts receivable or accounts payable in a foreign currency (or retires debt in a foreign currency).

Any currency gain (or loss) on a Section 988 transaction, is ordinary income or loss, not capital gain or loss. Therefore, since the transaction will often trigger an actual gain or loss in terms of the foreign currency, (i.e. before considering any exchange rate change) the transaction must be "bifurcated" (a fancy word also used in taxation). The gain or loss on the underlying transaction must be computed separately (generally as a capital gain or loss) and the foreign currency element is computed separately as ordinary income or loss.

An individual that sells "foreign" securities need not recognize exchange gain or loss between the trade and settlement dates. The settlement date is the date to be used. (IRC 988(c)(3)) and Reg. 1.988-2(a)(2)((iv)(A)) .

Section 988 may not apply if units of non-functional currency are exchanged for other units of the same nonfunctional currency, or where non-functional currency is put into a bank or certificate of deposit denominated in the same functional currency. See Reg. 1.988-2(a)(1)(iii).

NEXT ISSUE

In the next issue we will include considerable material on E-Commerce and cross-border transactions.

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