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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Estate Tax Status Update

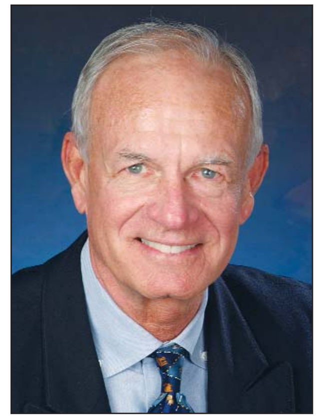
Under the existing US estate tax law there will be no federal estate tax during calendar year 2010. However several versions of estate tax legislation have been introduced in the Congress which would continue the estate tax in 2010 and beyond. For example see H.R. 3905, introduced October 22, 2009.

As we go to press the enactment of any of this legislation is not imminent as the Congress has been preoccupied with other legislation, including health care reform. It is likely that any legislation continuing the estate tax, when it is enacted act, will be retroactive to January 1, 2010.

Canadians With US Tax Withheld on Gambling Winnings

Canadians with US gambling winnings often have US tax withheld at source based on the gross amount received. Under the terms of the tax treaty, Canadians can file a US income tax return and potentially claim a full or partial refund of the tax withheld, by claiming a deduction for "substantiated" gambling losses. Only losses on bets whose gains would be taxable can be deducted. Similar rules apply to US citizens and US residents.

How do you substantiate your losses? A recent court case involving US citizens may also apply to Canadians claiming such losses. Although the taxpayer retained individual betting receipts, kept a journal of the net cash flow for each day's betting activity, and presented bank records showing substantial withdrawals of cash that corresponded to the journal entries, the taxpayer was not able to show that the gambling losses equaled or exceeded the gambling winnings because the taxpayer's spouse mistakenly discarded some of the betting receipts.



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 38 YEARS.

Nonetheless, because the taxpayer had established his gambling pattern, and presented sufficient records, the court estimated the gambling losses which were based, in greater part, on the estimate of the taxpayer's personal use of the winnings for expenditures other than wagering, and inconsistencies in the taxpayer's cash flow analysis.

However, although the taxpayer was allowed a partial deduction for losses, the IRS levied an "accuracy related penalty due to negligence" because adequate records to substantiate the losses were not maintained, and the taxpayer did not establish "reasonable cause" for the underpayment of the tax liability. (Dungca, T.C. Summary Opinion 2009-144, September, 18, 2009).

Canadian Banks May Be Required to Disclose Information to IRS

Numerous US legislative proposals have been introduced in the past year designed to suppress foreign tax abuses by giving the IRS increased powers to fight Bank secrecy. In addition to proposals presented earlier in the year, on October 26th the US administration announced a new IRS initiative to fight tax evasion by high-wealth taxpayers. A day later, on October 27th a proposal was introduced in the House of Representatives to force non-US financial institutions, etc. to provide information about their account holders who are US persons. (The "Foreign Account Tax Compliance Bill of 2009"). Non-US banks would have a choice - report on US account holders or lose access to US capital markets.

Retainer Fees & Bonuses Paid to Nonresident Professional Golf and Tennis Players

The IRS has advised that retainer fees paid to nonresident aliens pursuant to on-court endorsement contracts (e.g. contracts requiring an athlete to display, wear, or use equipment, clothing and footwear or other items during a sports activity) may constitute income from personal services and taxed at US graduated tax rates on the portion attributable to services performed in the US.

Similarly, ranking and placing bonuses (earnings attributable to performing at a certain level - e.g. winning or placing in a specific event), may also be taxed as income from personal services. (IRS Advice Memorandum 2009-005).

Beware Credit Card Debt Reduction

In a recent court case taxpayers engaged a separate service to negotiate a reduction in their credit card balance. The IRS (and courts) determined the amount of the reduction was taxable income to the taxpayer. Further they were not allowed to deduct the fee paid to the separate negotiating service. (R. F. Melvin, T. C. Memo 75,924(M)). Also, please see the article ***"REAL ESTATE "SHORT SALES" & OTHER MORTGAGE REDUCTIONS".***

States Stepping Up Sales Tax Compliance Efforts on Online Sales

In our International Tax Alerts (see our website) we mentioned the new sales tax legislation (existing or proposed) in New York, California, and Connecticut, that would impose sales tax on the downloading of digital goods, (music, movies, and other standard information) over the internet if certain factors are present. In New York, there is a rebuttal presumption that nexus exists for an out-of-State retailer if a *New York resident's website* provides a click-through link to the out-of-State retailer's website, and prescribed volume levels are reached.

Since then, Washington State, Kentucky, Vermont, Hawaii and North Carolina have enacted or introduced similar legislation.

Washington and Vermont Tax All Digital Products

Beginning July 26, 2009, Washington State sales *or* use tax applies to all "digital products", regardless of how they are accessed. Vermont legislation (The Fiscal Year 2010 Appropriations Act) also imposes sales and use tax on digital downloads.

Custom Software Exempt Sales Tax in Wisconsin

The Wisconsin Supreme Court ruled that a modular software system made up of standard software modules was not subject to Wisconsin sales tax. The seller mass-marketed the system to thousands of different businesses, but the system always had to be modified to fit a particular client's business needs. (Wisconsin Department of Revenue v. Menasha Corp. Wisconsin Supreme Court, No. 2004AP 3239)

US Tax Court Makes a Potentially Interesting Decision for Canadians for US Estate & Gift Tax

The US Tax Court has ruled that a single member LLC should be recognized as a separate entity from its owner for US federal gift tax valuation purposes. (Suzanne J. Pierre v. Commissioner, 133 T.C. No. 2, August 24, 2009, 2nd Circuit). The court's reasoning was that State law, rather than federal tax law determines the nature of a taxpayer's transferred ownership. Could US real estate be transferred from a nonresident alien to a single member LLC, and the LLC itself given to another family member without US gift tax?

Good News and Bad News for LLC Members (and LLP Partners)

Subject to exceptions, a "passive activity loss" cannot be offset against other "active" (non-passive) income, for US income tax purposes. For example, in certain cases real estate rental losses cannot be offset against salary income or securities gains. Code section 469(c)(1) defines a "passive activity", in part, as an activity in which the taxpayer does not "materially participate".

Section 469(h)(2) essentially provides a presumption (subject to regulations) that a limited partner in a limited partnership will not be treated as materially participating. Thus, in general, a limited partner that incurs losses in a partnership cannot deduct those losses against other "active" income.

The Good News - The tax courts have decided that although LLC (Limited Liability Company) members and LLP (Limited Liability Partnership) partners have limited liability (similar to limited partners in a limited partnership), Code Section 469(h) should not automatically apply to LLC members and LLP partners. In other words it should not automatically be presumed that they do not "materially participate".

Thus, the courts indicated that "material participation", rather than limited liability, should be the central issue in deciding whether LLC members and LLP partners should be able to deduct losses in the entity against active income. (See P.D. Garnett, 132 TC No. 19; J.R. Thompson, FedCl, 2009).

The Bad News - If LLC members are considered to "materially participate" they may be liable for US self employment tax, (subject to the terms of a Social Security Totalization Agreement).

US Lending Activities by Canadians Might be Taxable

The IRS has decided that interest income received by a foreign corporation on loans originated to US borrowers is US "effectively connected" income if any agent (dependent or independent) performs origination activities on the corporation's behalf with respect to the loans. (IRS Advice Memorandum AM-2009-010).

Cross-Border "Inflation-Adjusted" Figures for 2009/2010

The following inflation-adjusted figures will apply for calendar years 2009 and 2010:

- Foreign earned income exclusion:
  2009 - $91,400; 2010 - $91,500.
- Gift tax exclusion for gifts to a nonresident alien spouse:
  2009 - $133,000; 2010 - $134,000.
- General gift tax exclusion:
  2009 - $13,000 (no change);
  2010 - $13,000 (no change).
- Expatriation gain exclusion:
  2009- $626,000; 2010 $627,000.

CANADIANS INVESTING IN US REAL ESTATE PARTNERSHIPS

Generally, Canadians investing in US real estate rental partnerships (and certain other partnerships as well) must file US federal income tax returns, and often one or more individual State income tax returns.

Federal Income Tax Returns

The federal income tax filing requirement stems from the tax rule that a nonresident alien is taxed on income that is "effectively connected with a US trade or business". (§871(b)). A further rule provides that a nonresident alien will be considered engaged in a US trade or business if the partnership in which the individual is a member is engaged in US business. (§875(1)). Thus a federal tax filing requirement exists if the partnership is engaged in US business.

Under the tax treaty, there will be no actual federal tax liability if the partner does not have a "permanent establishment" (PE) in the US. However if the partnership itself has a PE in the US, the PE will likely be imputed to the foreign partner, and thus the partner will be considered to have a PE in the US.

Although the treaty does not specifically address the PE issue in this context, the Internal Revenue Service has taken the position that the imputation rule of §875(1) also applies for purposes of determining a partner's PE status. (See Revenue Ruling 90-80). Several court cases have concurred. (See Donroy Ltd v. US. 301 F.2nd, Unger v. Comr. T.C. Memo 1990-15, aff'd, 936 F.2nd 1316). Thus there could be a US federal tax liability for the Canadian partner if there is income or gain allocated to the partner by the partnership, and the partner has no other offsetting losses.

Each year the partnership issues IRS Form K-1, tax reporting form, to the partner after the end of the tax year, to indicate income, gain, and other tax attributes allocated to the partner. If there is "effectively connected taxable income" allocated to the partner, the partnership is required to withhold tax during the year on behalf of the foreign partner and remit it to the IRS. Please see the article **"*GENERAL WITHHOLDING RULES FOR FOREIGN & DOMESTIC PARTNERSHIPS WITH NON-US PARTNERS*".**

If there are only losses allocated to the partner on the Form K-1 it is still beneficial for the partner to file the federal income tax return in order to record the losses so they can be carried forward to future years to offset against profit or gain in those years.

State Income Tax Returns

A real estate partnership will, of course, normally own rental real estate in one or more individual States. The existence of rental real estate in a particular State will generally create "nexus" and therefore a filing requirement for the partner in that State, assuming the State levies an income or franchise tax. Generally a State will consider real estate rental income from real estate in that State as being sourced in that State, therefore triggering the filing requirement. If there is a State filing requirement the partnership will usually issue a separate K-1 for that State, or provide a separate schedule indicating the allocation of the total partnership income to various States. If there are only losses allocated on a K-1 for a particular State, it still may be beneficial to file an income tax return in that State to record the losses for use in that State in future years.

INDIVIDUALS INVOLVED IN US REAL ESTATE "SHORT SALES" & OTHER MORTGAGE REDUCTIONS

Generally, subject to exceptions, if another person cancels or reduces a debt you owe to them, the result is taxable income to you for the amount forgiven. (Code Section 61(a)(12)). The amount taxable can be referred to as "cancellation of indebtedness" income, (COD income) or "discharge of indebtedness income".

A frequent real estate transaction today in some parts of the US is a "short sale" - a procedure by which a mortgage lender refrains from foreclosing on a delinquent borrower/owner while the borrower/owner and the lender jointly seek a buyer, usually when the unpaid mortgage balance exceeds the value of the property. In such cases the lender might not pursue collection of all or part of the eventual unpaid deficiency, once a sale to a new owner is concluded. Hence there is COD income to the existing borrower/owner.

Similarly, there could be COD income if the lender actually forecloses on the property, and/or perhaps the borrower/owner simply "walks away from the property", and the lender does not pursue any deficiency.

The IRS can be notified of this COD income by the lender, because the lender is required to report a property's foreclosure or abandonment on IRS Form 1099A. Also certain lenders are required to report to the IRS the borrower's COD income on IRS Form 1099C, Cancellation of Debt.

Full or partial exemptions from this rule include:

a) Bankruptcies,
b) Otherwise insolvent taxpayers,
c) Indebtedness which is "Qualified Farm Indebtedness",
d) Certain "Principal Residence Indebtedness" which is discharged before January 1, 2013,
e) Certain "Qualified Real Property Business Indebtedness", and
f) Certain Student Loans.

See IRC §108.

Also, in certain cases the COD income arising from business indebtedness discharged by the reacquisition of the debt instrument can be included in gross income over a five-year period. (IRC §108(i)).

Qualified Principal Residence Indebtedness

Qualified Principal Residence Indebtedness means "acquisition indebtedness". "Acquisition indebtedness" is debt secured against the property which was incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer, with an upper limit, which rises to $2 million in some cases. A qualified residence means the principal residence of the taxpayer. (§108(h)(2) and §163(h)(4)).

If you exclude an amount from income under this provision, you must reduce the cost base of your principal residence (but not below zero) by the amount of the exclusion. (§108(h)(1)). Exceptions apply.

Qualified Real Property Business Indebtedness.

"Qualified Real Property Business Indebtedness" which is discharged, is exempt from taxable income if the indebtedness is secured against property used in a trade or business, and was either incurred before January 1, 1993, or, if it was incurred or assumed on or after that date, is indebtedness which was incurred to acquire, construct, reconstruct or substantially improve real property used in a trade or business. This exclusion is not available to "C" corporations and there are limits to the amount that can be excluded. (IRC §108(c)).

The taxpayer must elect to claim this exclusion. Generally, the basis of the property must also be reduced if there is an exclusion. (See §108(c) but see also "***Reduction of Tax Attributes***", below).

Reduction of Tax Attributes

If a taxpayer excludes COD income he/she may be required to reduce certain tax attributes associated with his/her tax status, such as net operating losses, net operating loss carryovers, general business credit carryovers, minimum tax credits, capital loss carryovers, as well as cost basis reductions.

Many other related rules apply. Please contact your tax advisor before taking any action.

Also, please see the paragraph on page 2 "***Beware Credit Card Debt Reduction***".

Query - What is the status of nonresident aliens resident in Canada who own US rental real estate which is subject to foreclosure, a short sale, or other mortgage reduction? Is there COD income?

US REALTY SALES BY CANADIAN AND US PARTNERSHIPS AND LLCs – THE "FIRPTA" (IRC §1445) RULES

A US withholding tax of 10% of the selling price ("FIRPTA" withholding) generally applies at the time of sale when US real estate is sold by:

1) A nonresident alien,
2) A foreign (non-US) corporation,
3) A foreign partnership, or
4) A foreign trust or estate.

As usual there are exceptions, please see Exhibit 1 as an example. (Please see the Fall, 2002, Taxletter for a description of some of the rules. Call us for a free copy if you wish).

However, different or additional rules for the FIRPTA withholding may apply when:

1) The seller is a partnership (foreign or domestic),
2) The seller is a US LLC,
3) The seller is a domestic (US) trust or estate,
4) The seller is a "grantor" trust,
5) A domestic or foreign partnership, trust, or estate distributes US real estate to a partner or beneficiary, or
6) An ownership interest in partnership owning US real estate is sold.

The Seller Is a Partnership

The rules for the sale of real estate by partnerships (foreign or domestic) are made complex by the fact that at least two different Code Sections may apply. The normal FIRPTA rule of §1445(a) requires a withholding of 10% of the selling price if the seller is a foreign partnership.

However an entirely different Code Section (1446) levies withholding tax on any partnership (foreign or domestic) which has "effectively connected taxable income" (real estate and otherwise), to the extent the income is allocable to foreign partner. Please see the separate article "***GENERAL WITHHOLDING RULES FOR FOREIGN & DOMESTIC PARTNERSHIPS WITH NON-US PARTNERS***". Thus a combined set of rules may impact a Canadian partnership selling US real estate.

A domestic partnership with a foreign partner that sells US real estate, (and would therefore potentially be subject to the rules of both §1445 and §1446), is, instead, subject only to the rules of §1446. (Reg. 1.1446-3(c)(2)(i)). See Domestic Partnership, below.

Foreign (non-US) Partnership.

As indicated, §1445(a) levies "FIRPTA" withholding at 10% of the selling price on the sale of real estate whenever a foreign partnership sells US real estate. However, since a foreign partnership is likely to have a foreign partner, the rules of §1446 will normally apply in addition to, (not instead of) the rules of §1445. This means there will be withholding tax at the time of the sale of real estate and there may also be a quarterly withholding tax requirement as described in the article "***GENERAL WITHHOLDING RULES FOR FOREIGN & DOMESTIC PARTNERSHIPS WITH NON-US PARTNERS***". However the partnership may credit amounts withheld under §1445 against the withholding obligation under §1446. (Reg. 1.1446-3(c)(2)(ii)).

Domestic Partnership.

As explained above, when a domestic partnership sells US real estate the normal FIRPTA withholding rules of §1445 are overridden by the rules of §1446. (Reg. 1.1446(3(c)(2)(i)).

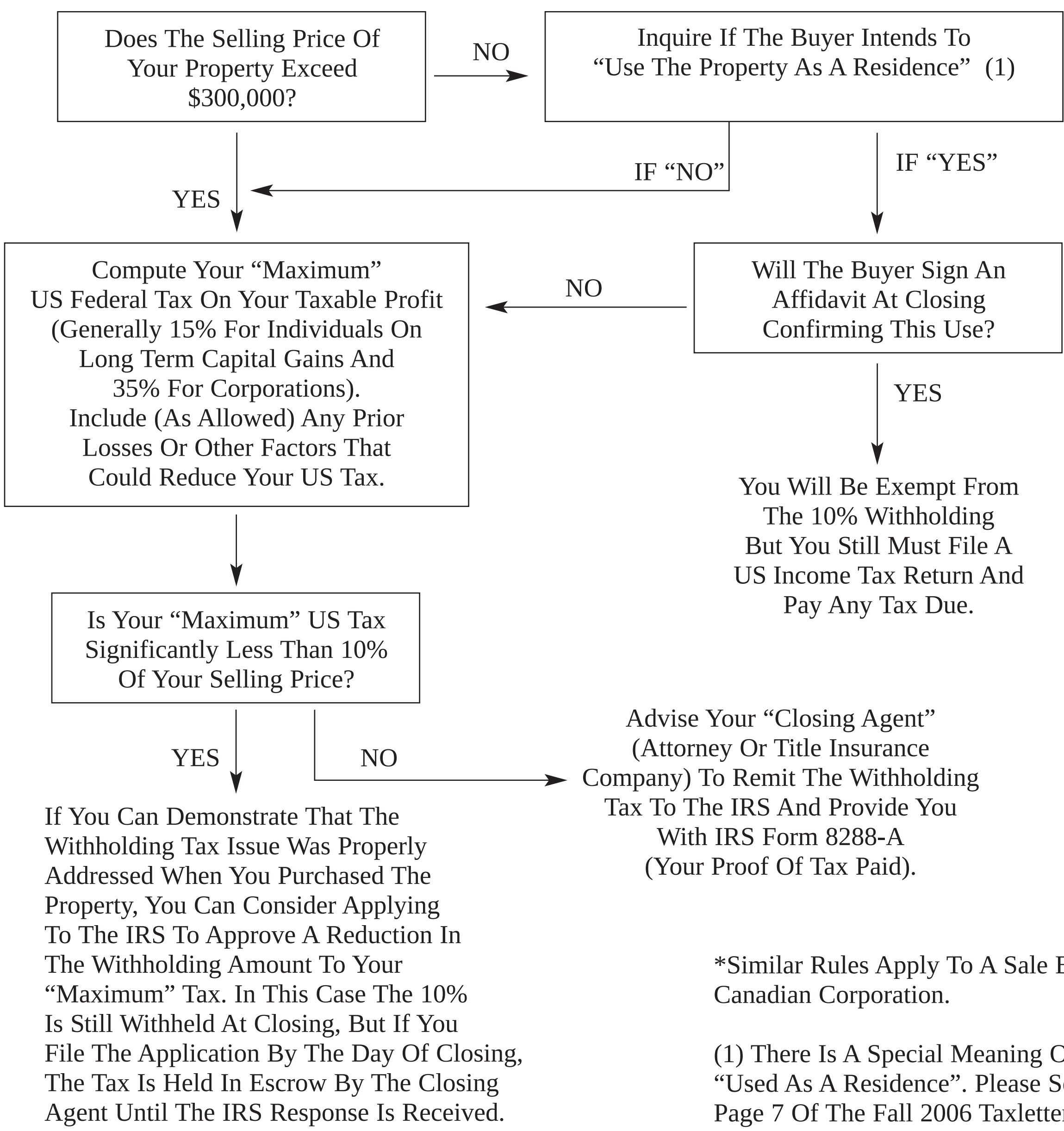
In this case quarterly withholding is required, instead of withholding at the time of sale. The first withholding payment under section 1446 is due no later than four months from the sale date. Since §1445 is not applicable, the partnership cannot apply for a withholding certificate to reduce the withholding.

The Seller Is a US LLC

Single Member LLC. When the seller is a single member LLC (owned by one person) the FIRPTA rules are applied on the basis of the status of the owner of the LLC, not the LLC itself. Thus if the seller is a United States LLC that is a disregarded entity, the LLC can not certify that it is a US person, and thus avoid FIRPTA withholding. Instead, the owner of the disregarded entity is treated as the transferor of the property. (See CCA 200836029).

EXHIBIT 1

US Withholding Tax On Nonresident Alien's Sale Of US Real Estate*



*Similar Rules Apply To A Sale By A Canadian Corporation.

(1) There Is A Special Meaning Of "Used As A Residence". Please See Page 7 Of The Fall 2006 Taxletter.

If the owner of the LLC is a US person and provides the proper documentation there will be no FIRPTA withholding. For this purpose the regulations provide a sample certification. See Reg. 1.1445-2(b)((iv)(B)).

However if the owner of the single member LLC is a foreign individual, corporation, trust, or estate, the regular FIRPTA rules applicable to foreign individuals, corporations, trusts, or estates will apply. (Reg. 1.1445-2(b)(2)(iii) and CCA 200836029).

LLC That Is Taxed As a Partnership. If the US LLC is being taxed as a partnership in the US, the above rules applicable to the sales by a partnership apply.

LLC That Is Taxed As a Corporation. If the LLC has elected in the US to be taxed as a corporation the FIRPTA withholding tax does not apply since the seller is now a domestic corporation.

The Seller Is a Domestic (US) Trust or Estate

When US real estate is sold by a domestic trust or estate the Trustee of the trust, or the Executor of the estate, must withhold tax equal to 35% of the gain (15% in the case of certain long-term capital gains) allocable to a foreign beneficiary when there is a distribution of the gain to the foreign beneficiary, (i.e. not when the sale occurs). (§1445(e)(1)) and Reg. 1.1445-5(c)(1)(iii)(A)).

Special rules may apply to large trusts, and publicly traded trusts.

The Seller is a "Grantor Trust"

The fiduciary of a grantor trust must withhold tax of 35% of the gain the trust realizes on the disposition of US real estate, to the extent the gain is allocated to a foreign person. (Reg. 1.1445-5(c)(1)(iv)).

A "grantor trust" is, generally, a trust in which the grantor (or other designated person) possesses certain defined powers over, or rights in, the trust.

A Partnership, Trust, or Estate Distributes US Real Estate

The tax code gives the government authority to issue regulations requiring a domestic or foreign partnership to withhold a tax of 10% of the fair market value of US real estate distributed to a partner of the partnership, or a beneficiary of the trust or estate, who was a foreign person, in a transaction which would constitute a taxable distribution under regulations issued under §897. (§1445(e)(4)). However regulations have not yet been issued under Reg. 1.1445-5(f)). Withholding may nonetheless be required to the extent the distribution is attributable to the entity's distribution of real estate to a third party. Please contact your tax advisor before proceeding.

An Ownership Interest in a Partnership Owning US Real Estate Is Sold

If 50% or more of a partnership's assets are US real property interests, and if 90% or more of its assets are made up of US real property interests, cash, and cash equivalents, then the portion of an interest in a partnership attributable to the real property interests will be subject to withholding when a foreign partner sells an interest in the partnership. (Reg.1.1445-11T(b)).

GIVING UP YOUR GREEN CARD - MORE ON EXPATRIATIONS

Readers are aware the United States now has a form of "exit tax", or "departure tax", which has some similarities to Canada's rules. The US rules vary depending on whether the expatriation occurred before June 17, 2008, or after June 16, 2008. The rules apply to US citizens who renounce US citizenship and green card holders who are classified as "long-term residents" who give up their green cards. Please see the Summer, 2008, Taxletter.

Canadians whose green cards have expired often incorrectly believe they no longer have a green card! An individual does not "give up" a green card simply because the card itself has expired. There is a formal procedure required to officially abandon a green card.

For an excellent article on the US income tax aspects of expatriations please see "*The Increased Cost of Expatriation: Is This the Final Chapter?*", by Thomas S. Bissell, Esq. in the July, 2009, issue of *Tax Management International Journal* issued by the Bureau of National Affairs. See also IRS Notice 2009-85.

EXPATRIATION'S AFTER JUNE 3, 2004 AND BEFORE JUNE 17, 2008
(The Section 877 Rules)

Effective Date of the Expatriation

Code Section 877 applies to expatriations after June 3, 2004, and before June 17, 2008. Under section 877 the effective date of the expatriation for income tax purposes is the later of the "expatriating act" or the date on which the individual files IRS Form 8854.

Thus an individual renouncing US citizenship or a "long-term resident" giving up a green card during this period continues to be taxed as a US citizen or US resident until Form 8854 has been filed. (See page 1 of the instructions to Form 8854 and Former IRC §7701(n)(2)).

This result stems from the fact that, although Section 877(a) states that an individual who expatriates will only be subject to the tax rules of Section 877(b), (i.e. under the rules of section 872 with special source rules), Section 877(a) is overridden by Section 7701(n) as it existed up to June 17, 2008. Section 7701(n) longer applies for any individual whose "expatriation date" is after June 16, 2008 - see P.L. 110-245, effective date, but continues to apply to individuals who expatriated before June 17, 2008 - see IRS Notice 2009-85.

A "long-term resident" is an individual who is a lawful permanent resident of the United States (holds a green card) in at least 8 taxable years during the period of the last 15 taxable years. Generally an individual will not be treated as a lawful permanent resident for any tax year the individual claimed Article IV benefits under the tax treaty. (IRC §877(e)(2)).

Filing Form 8854

Individuals Who do Not Meet the Tax Test or Net Worth Test. An individual who does not meet either the average tax test or the net worth test is only required to file the initial Form 8854, provided he/she certifies on Form 8854 compliance with all federal tax obligations for the five years preceding the expatriation. (Instructions to Form 8854). See the Summer, 2008, Taxletter for an explanation of the average tax test and net worth test. For such individuals, after Form 8854 has been filed, the individual is taxed thereafter as a "normal" nonresident alien.

Any such individuals now filing Form 8854 must use the new (existing) Form 8854, not the one issued before April, 2009.

There is no due date for Form 8854. (Instructions to Form 8854). But apparently there is a $10,000 penalty for failure to file. (IRC §6036G(c)).

Individuals Who ***Do*** Meet the Tax Test or Net Worth Test. An individual who does meet either the average tax test or net worth test is subject to the "worst" of two tax regimes for the following 10 years (i.e. whichever results in a higher tax). (IRS Notice 2009-85, Section 4). The two tax regimes are, the normal tax regime for nonresident aliens, and the "Alternative Tax Regime" of Section 877(b). (See below).

Further, such individuals must continue to file Form 8854 for each year for 10 years following the year of expatriation even if there is no tax due. (IRC §6039G(a) and IRS Notice 2009-85, Section 4).

Any such individuals currently filing Form 8854 use the new (existing) Form 8854, not the one issued before April, 2009.

As above, there is no due date for Form 8854. (Instructions to Form 8854). However it appears there may be a $10,000 penalty for failure to file. (IRC §6036G(c)).

Taxation under Section 877(b) (The "Alternative Tax Regime")

Under the "alternative tax regime" an individual is subject to US tax as a regular nonresident alien except that the special "source rules" of §877(d) apply. (§877(b)). This means, for example, you may still be subject to US tax on the sale of certain US securities for the next 10 years even though you have properly complied with all the expatriation rules.

Note that technically (subject to exceptions) an individual who expatriated under these rules, will nonetheless be considered a resident of the US in any calendar year during the 10 year period following the expatriation in which the individual is physically present in the United States on more than 30 days. (IRC §877(g)).

The rules of §877(b) do not apply to expatriations after June 16, 2008.

EXPATRIATION'S AFTER JUNE 16, 2008
(The Section 877A Rules)

Code Section 877A governs expatriations after June 16, 2008. Apart from the imposition of the "mark to market" rule and other complex provisions, the legislation enacting §877A made two other noteworthy changes.

First, former Code Section 7701(n) was deleted. That section formerly stated that an individual who expatriated would nonetheless continue to be treated as a citizen or resident until Form 8854 was filed.

Second, new language was added to Code Section 7701(b)(6). Simplistically, the new language states that an individual with a green card will no longer be treated as a lawful permanent resident of the United States if the individual makes a proper tax treaty claim according to Section 7701(b)(6)(B) and Reg. 301.7701(b)-7 to be treated as a nonresident alien, and does not waive treaty benefits.

Thus, for green card holders, after June 16, 2008, Section 7701(b)(6) not Section 7701(n) becomes the operative section to determine the "expatriation date" and the date when a "long-term resident" has expatriated. (IRC §877A(g)(3)).

Who Is Subject to the Section 877A Expatriation Rules?

If you are an expatriating US citizen or “long-term resident” you are generally subject to the expatriation rules (i.e. you are a "covered expatriate") if:

1) You meet either the average annual net income tax test or the net worth test, or

2) You fail to certify on Form 8854 *by the due date* that you have complied with all federal tax obligations for the five years preceding the date of your expatriation.

(Certain exceptions apply).

The two tests are described in the Summer, 2008, Taxletter.

Effective Date of the Expatriation

Unlike the rule in effect up to June 16, 2008, for expatriations after June 16, 2008, the effective date of the individual's expatriation for tax purposes will now normally be the date of the expatriating act, without regard to when the individual files Form 8854. (IRC§877A(g)(3)). Therefore the effective date of the expatriation is:

1) The date an individual relinquishes United States citizenship, or

2) In the case of a "long-term resident" the date on which the individual ceases to be a lawful permanent resident of the United States within the meaning of Section 7701(b)(6) - i.e. the earlier of the day in which the individual actually gives up the green card, or the date on which the individual 1) commences to be treated as a nonresident under a tax treaty, 2) does not waive the benefits of the treaty, and 3) notifies the IRS of such treatment on Forms 8833 and 8854. (IRS Notice 2009-85, Section 2 "Expatriation Date").

The expatriation rules, (including the "mark to market" and deemed disposition rules) apparently apply to an individual who fails to file Form 8854 by the due date, even if he/she does not meet either of the "two tests"! (IRS Notice 2009-85, Section 8 C.)

Filing Form 8854

The individual must file IRS Form 8854 for the year of expatriation. It appears if the individual settles the entire US income tax liability in the year of the expatriation (and has no deferred income tax liability under any of the various exceptions to the "mark to market" rule) he/she is only required to file Form 8854 for the year of expatriation. (IRC§6039G(a)).

The due date for Form 8854 is the due date, including extensions, for the tax return for the tax year covering the day immediately prior to the expatriation date. There is a $10,000 penalty for failure to file. A dual status return is normally required unless the expatriation date is January 1st. (IRS Notice 2009-85, Section 8).

What is the status an individual who does not meet either of the "two tests" but who fails to file Form 8854 by the due date? It appears both the $10,000 penalty, and the "mark to market" and other expatriation rules described below, apply.

The Mark to Market Rule

Generally, an individual who expatriates after June 16, 2008, and is a "covered expatriate" is deemed to dispose of his/her worldwide assets at fair market value, just prior to the expatriation. There is a potential inflation-adjusted $600,000 exemption and a potential deferral election. (IRC 877A(a)). Please refer to the Summer, 2008, Taxletter.

Also, recall that property which was held by an individual on the date the individual first became a resident of the United States can be treated as having a cost basis on that date of not less than the fair market value of the property on that date for purposes of the expatriation rule. (IRC 877A(h)(2)).

However the above rules, including the inflation-adjusted $600,000 exemption and the deferral election do not apply to three kinds of property that are subject to a special set of rules instead of the general "mark to market" rules. These include:

1) "Deferred Compensation Items" (IRC 877A(d)),

2) "Specified Tax-Deferred Accounts" (IRC 877A((e)), and

3) "Any Interest in a Non-Grantor Trust" (IRC 877A(f)).

Deferred Compensation Items

Deferred compensation items comprise "eligible" and ineligible" items. They include (but are not limited to):

1) Most US tax "qualified" pension, profit sharing, and stock bonus plans,

2) Any interest in a foreign pension plan or similar retirement arrangement or program, and

3) Any item of deferred compensation.

Generally, "eligible" items will not be taxed until they are actually paid out at a later date. A 30% US federal income tax will be withheld at the time they are paid out, except to the extent the item is attributable to services performed outside the United States while the individual was not a US citizen or US resident. (IRC §877A(d)(1) and (5)).

Unfortunately, if the payer is a non-US person, (for example in the case of a foreign pension plan) the payer must file an election with the IRS to be treated as a US person, so that the payer will be responsible for the 30% withholding. (See Code Section 877A(d)(3)).

If the foreign payer is unwilling to make such an election, the entire net present value of the interest in the foreign pension plan (except, perhaps, to the extent the value is attributable to services performed outside the United States while the individual was not a US citizen or US resident) will be immediately subject to the mark to market rule at the date of the expatriation, and the $600,000 exemption (adjusted for inflation) will not be available!

In the case of "ineligible" items, the taxpayer is generally subject to tax on the item as if it was received on the day before the expatriation date. (IRC §877A(d)(2)((A)). For a definition of "deferred compensation items", "eligible" items, and "ineligible" items, please see Notice 2009-85, Sections 5B(1), (2), and (3)).

Surprisingly it appears the net present value of the expatriate's US Social Security benefits might be subject to the mark to market rules of Code Section 877A(a) - i.e. immediate taxation subject to the inflation-adjusted $600,000 exemption, rather than the rules of Code Section 877A(d). (Please see the relevant discussion included in the aforementioned analysis by Thomas Bissell, Esq.).

Specified Tax-Deferred Accounts. Certain specified kinds of US tax-deferred accounts are subject to tax at the time of the expatriation and are not eligible for the inflation-adjusted $600,000 exemption or either of the deferral elections available for "gains" or for "deferred compensation items". (See §877A(e)) and Notice 2009-85, Section 6).

Any Interest in a Non-Grantor Trust. There is an automatic deferral of income tax on any "interest in a non-grantor trust", whether the trust is a domestic trust or a foreign trust. (IRC §877A(f)). When a distribution does occur, rules similar to the payments described under "eligible deferred compensation" above apply. In other words the trustee is required to withhold 30% of the amount of the distribution, and the expatriate's actual tax liability is then computed as a nonresident alien. It appears treaty benefits may be available when computing the actual tax liability. Please consult your tax advisor before taking any action.

Individuals with "deferred compensation items", "special tax-deferred accounts", or any interest in a non-grantor trust must file IRS Form W-8CE with the relevant payer by a deadline. (Notice 2009-85, Section 8D).

GENERAL WITHHOLDING RULES FOR FOREIGN & DOMESTIC PARTNERSHIPS WITH NON-US PARTNERS(THE §1446 RULES)

The tax code applies a withholding tax on the "effectively connected taxable income" of both domestic and foreign partnerships, that is attributable to a foreign partner.

Thus, generally, any Canadian or US partnership that is engaged in business in the US or has US real estate rental income or real estate sales, and has a Canadian partner, is subject to US withholding tax rules requiring remittance of installment tax payments during the tax year, regardless of whether the income is distributed. (§1446).

As indicated in the article "***US REALTY SALES BY PARTNERSHIPS AND LLCs***" if the partnership is a foreign partnership that sells US real estate, the partnership is subject to both the FIRPTA withholding rules of §1445, and the rules described here under §1446. If the partnership is a domestic partnership that sells real estate it is subject only to the rules of §1446.

A partnership determines its "effectively connected taxable income" allocable to a foreign partner using the "aggregate" approach. Thus, generally, when computing the withholding, the regulations do not permit the partnership to take into account any losses of a partner that are carried over or carried back, or are suspended under the passive activity lost rules. Also, generally, the partnership is not allowed to take into account any net operating loss carryovers or charitable contributions. (Reg. 1.1446-2). If a foreign partner has elected to treat real property as income effectively connected with a US business, the income is included in calculating the partnerships "effectively connected taxable income".

However under Reg.1.1446-6 the partnership is allowed to consider certain partner-level deductions and losses of the partner if the partner files a certification with the partnership on IRS Form 8804-C. (Reg. 1-1446-6).

The partnership must pay the tax in four installments during the year with the final payment after the end of the year. Installments are due on the 15th day of the fourth, sixth, ninth, and 12 months of the partnership's taxable year. The final payment is due at the same time as the partnership's annual tax return.

The tax for each installment is based on the highest tax rate applicable to that type of taxpayer (generally 35% federally, except in the case of certain long-term real estate gains allocable to a non-corporate partner).

Note - a publicly traded partnership is subject to Section 1446 on its distribution of effectively connected income to its foreign partners, and not on the income as it is earned (Reg. 1.1446-4(a)).

IRS TAXPAYER NUMBERS REQUIRED FOR CANADIANS FOR REALTY SALES AND WITHHOLDING APPLICATIONS

The IRS will not process an individual's U.S. income tax return unless a U.S. tax identification number (or, in the case of a nonresident alien, an application for one), is included. The IRS similarly requires tax ID numbers on other Forms such as withholding tax remittance Forms 8288 and 8288-A, and Form 8288-B (Application for reduction in "FIRPTA" withholding tax on a real estate sale). See Exhibit 1.

Form 8288-A

When U.S. real estate is sold by a non-U.S. person and U.S. withholding ("FIRPTA") tax is withheld, the tax must be remitted to the IRS with Forms 8288 and 8288-A. The instructions to Form 8288 require the seller and buyer to insert either the social security number ("SSN"), employer identification number ("EIN"), or for a nonresident alien individual who is not eligible for a social security number, they may enter their individual taxpayer identification number ("ITIN").

If either the seller or buyer is any entity other than an individual (for example, corporation, qualified investment entity, estate, or trust) they may apply for an EIN online or by phone and receive the number immediately.

If the seller or buyer is a nonresident alien individual and does not have a SSN or ITIN he/she may complete an application for an ITIN and submit it along with the Form 8288-A to the Internal Revenue Service for processing. The application must include a U.S. notarized copy of the applicant's unexpired passport or a Certificate of Acceptance by an agent authorized by the IRS. If the individual does not have a passport he/she may provide a combination of documents that contain expiration dates to prove identity and foreign status.

After the IRS has processed both the ITIN application and Form 8288, the seller will receive a stamped copy of Form 8288-A (copy B), which will be the receipt for tax and must be attached to the tax return filed the following year reporting the sale.

Form 8288-B

When U.S. real estate is sold by a non-U.S. person and the seller wishes to apply to reduce or eliminate "FIRPTA" withholding tax, the seller (or other party) files IRS Form 8288-B with the IRS. The instructions for Form 8288-B state an application may only be made if the application is based on:

1) A claim that the transferor is entitled to nonrecognition treatment or is exempt from tax,

2) A claim solely on a calculation that shows the transferor's "maximum tax liability" is less than the tax otherwise required to be withheld, or

3) A claim that the special installment sales rules described in section 7 of Rev. Proc. 2000-35 allow reduced withholding.

Form 8288-B also requires both the buyer and the seller to have a US taxpayer identification number (or, in the case of a nonresident alien, to apply for one).If on the date of transfer, an application for a "withholding certificate" is, or has been, submitted to the IRS, the applicable withholding is not required to be paid over to the IRS until the 20th day after the day that the IRS mails the withholding certificate or notice of denial. However, ten-percent of the gross sales price must be held in escrow by the closing agent until a response is received from the IRS.

After a response is received, the withholding agent will either remit the required tax due in accordance with the IRS withholding certificate using Form 8288 and 8288-A, or return the tax withheld to the seller. The seller must still file a U.S. tax return the following year reporting the sale.

THE SOCIAL SECURITY TOTALIZATION AGREEMENT AND CANADIAN EMPLOYEES SENT TO THE US

Readers know there is a social security tax treaty separate from the income tax treaty. (The Social Security Totalization Agreement). The Agreement generally exempts Canadian employees from US Social Security tax if they are sent to work in the US by a Canadian employer for five years or less.

Suppose the Canadian employer sends the Canadian employee to work in the US for a subsidiary of the Canadian employer for five years or less. Does the exemption apply? Apparently the exemption still applies if the Canadian corporation "controls" the employee.

What is meant by "control"? If the US corporation and the US employee's salary are funded by the Canadian corporation then the Canadian corporation may "control" that employee. On the other hand if the US corporation is making a profit and paying the employee out of its own profits then the Canadian company may not be "in control" of the employee. Nonetheless, if the US corporation is making a profit, but it invoices the Canadian corporation for the employee's salary, then the Canadian corporation may be "in control" of the employee and the Social Security would be paid to Canada.

When the Social Security is payable in Canada, a normal IRS W-2 wage statement would be issued to the employee, but no US Social Security would be withheld and remitted. To validate this, a certificate of coverage from Canada should be obtained.

COST BASIS STEP-UP WHEN MOVING TO THE US

In the 2009 Winter/Spring Taxletter we mentioned that the 5th Protocol amended Article XIII(7) of the tax treaty to provide certain individuals, in effect, with an election to increase their cost base in certain property when they move from Canada to the US. The election is an election to have a deemed disposition for US purposes if there was a deemed disposition for Canadian purposes. For nonresident aliens moving to the US, the election applies to individuals that moved (had a deemed disposition for Canadian purposes) after September 17, 2000.

Effect on Canadian Nonresident Aliens Moving to the US

The most common situations in which this applies to nonresident aliens moving to the US from Canada are circumstances where the Canadian resident owns publicly traded securities, a Canadian private corporation, or US or other non-Canadian real estate.

Generally, an individual departing Canada is deemed to dispose of these assets at fair market value for Canadian tax purposes at the time of becoming a nonresident of Canada. Nonetheless, under the US domestic tax rules, the nonresident alien individual still retains his/her original historical cost base for US purposes. Thus, absent Article XIII(7), double tax could result because the appreciation in the property up to the date of departure from Canada could be taxed twice -- in Canada at the date of departure, and in the United States at the time of sale.

Under Article XIII(7) the taxpayer may elect to be treated in the US in the year that includes the deemed disposition, and all subsequent years, as if the individual had, immediately prior to the departure, sold and repurchased the property for an amount equal to its fair market at the date of departure.

Thus Article XIII(7) prevents double taxation by giving the nonresident alien individual from Canada a cost base for US purposes equal to the fair market of the property as of the date of the deemed disposition in Canada. Article XIII(7) also applies to US citizens, but since they are subject to US tax "immediately prior to departing from Canada" the elected gain is actually taxable in the US, and there is a potentially offsetting foreign tax credit for the Canadian departure tax.

There is some uncertainty over how the election under Article XIII(7) operates. For example, is the election made in the year of the sale of the relevant property, or is it made in the year the individual first becomes a US resident? What is the status of a nonresident alien who moved to the US after September 17, 2000, but sold relevant property in, say 2003, a year now generally barred from amendment by the statute of limitations. Can such an individual file an amended return for the year 2003 anyway?

We spoke with the IRS and determined guidance is being prepared and a Revenue Procedure will be issued in due course. It appears for the moment, for sales of relevant property in 2008, and prior years not barred by statute, it is appropriate to make the election and treaty claim in the year of sale of the property. But we were advised it appears likely that when guidance is issued it will require the election and treaty claim to be made in the year the individual becomes a US resident. It appears possible that anyone who sold property in a prior year barred by the statute of limitations will not be able to file an amended return to make the election and treaty claim.

Example: Sam, a nonresident alien of the US moves from Canada to the US in 2002 while owning publicly traded securities with a market value of $100,000 and cost base of $50,000. At the time of the departure Sam is subject to Canadian departure tax on the capital gain of $50,000. In 2008, while a resident of the United States, Sam sold the securities for $120,000. If Sam makes the appropriate US election on his 2008 US income tax return (or amended return), Sam is subject to US tax on gain of only $20,000 because his cost base for US purposes becomes $100,000.

Please consult you tax advisor before taking any action.

(Note - individual State income tax rules may require the use of the historical cost base for State income tax purposes).

US TAXATION OF DISTRIBUTIONS FROM FOREIGN NON-GRANTOR TRUSTS (REAL ESTATE SALES BY CANADIAN DISCRETIONARY TRUSTS)

The US taxation of the distribution from a trust depends in part on whether the trust is:

1) A grantor trust or non-grantor trust,
2) A domestic trust or foreign trust, and
3) A simple trust or complex trust.

Grantor Trust or Non-Grantor Trust. Generally, a grantor trust is a trust that is considered to be owned (under the rules of Code Section 671-677) by the grantor, the person who created the trust, in which case the grantor is taxed on transactions in the trust. If the trust is a grantor trust, the trust generally does not exist for US income tax purposes and the grantor is taxed instead.

Also, if a person other than the grantor has certain powers over the trust, that individual may be treated as the owner of all or part the trust and therefore, like the grantor, taxed on all or part of the transactions in the trust. (IRC 678).

Further if a United States person transfers property to a foreign trust that has a US beneficiary, the US person making the transfer to the trust may be considered the owner of all or part of the trust, and therefore taxed on all or part of the transactions in the trust. (IRC 679).

However note the rules of Section 672(f) which restricts the circumstances under which a foreign trust will be treated as a grantor trust.

This article address only foreign non-grantor trusts.

Domestic Trust or Foreign Trust. For a summary of the rules to determine whether a trust is a domestic (US) trust, or foreign trust, please see the Summer, 2006, Taxletter.

Simple Trust or Complex Trust. A trust is a simple trust if:

1) All income must be distributed currently,

2) No amounts may be paid, or permanently set aside for, or used for a charitable beneficiary, and

3) No distributions are made other than of current income (i.e. no distributions of accumulated income or corpus).

Simple Trust.

All the income of a non-grantor foreign simple trust is taxed annually to the beneficiaries, (regardless of whether it is distributed) and the trust will receive a deduction for its income that is required to be paid to the beneficiaries, (regardless of whether it is distributed). The amount included in income of the beneficiaries, and the amount of the deduction to the trust, is limited to the trusts "distributable net income" (DNI).

The DNI of a simple trust is generally it's taxable income, computed without the "deduction for distributions to beneficiaries", and the personal exemption, and increased by any tax exempt interest. The "deduction for distributions to beneficiaries" of a simple trust is "the amount required to be distributed". (IRC §651).

The DNI of a foreign trust (simple or complex) is computed slightly differently than the DNI for a domestic trust. For example, in a domestic trust, capital gains are often excluded from DNI, but in the case of a foreign trust they are usually included in DNI. (§643(a)(3); Reg. §1.643-(a)-3).

Complex Trusts. A beneficiary of a foreign non-grantor complex trust includes in income all the income that the trust is required to distribute to him/her, and all the income actually distributed to him/her pursuant to the governing document, limited to an amount equal to that beneficiary's pro rata share of the trusts current DNI, unless there is an accumulation distribution. (Simplistically, an accumulation distribution can occur if DNI in a prior was not distributed or required to be distributed).

The DNI of a complex trust is generally it's taxable income, computed without the deduction for "distributions to beneficiaries", and the personal exemption, and increased by any tax exempt interest. The "deduction for distributions to beneficiaries" of a complex trust is "the amount required to be distributed" and the amount actually distributed. (IRC §661).

A distribution to a beneficiary in excess of the beneficiary's share of the trusts DNI is treated as a nontaxable distribution of principal or a distribution of income accumulated from prior years (an "accumulation distribution"). The latter is taxable under the throwback rule - see "Accumulation Distributions" below.

The amount distributed to the beneficiary (and the amount required to be distributed) is included in the beneficiary's taxable year in which the trust's taxable year ends (usually December 31st).

The trust receives a deduction for that portion of its current income that it is required to distribute, plus that portion of its income that the trustee actually distributes pursuant to the governing instrument. The trust's deduction is limited to the amount of its DNI.

Unlike a domestic trust, the capital gains of a non-grantor foreign trust are included in DNI, regardless of the governing instrument, and regardless of whether they are currently distributed.

The US income tax consequences to beneficiaries of distributions from a non-grantor foreign complex trust depend upon whether:

1) The distribution represents current income, or accumulated income,

2) The beneficiary is a US person or foreign person, and

3) The trust's income is from US sources or foreign sources.

Current Distributions

Beneficiaries are taxed on income that is either distributed or required to be distributed.

US Beneficiaries. The US beneficiaries must include in their income any distributions (or required distributions) of US and foreign income, to the extent of their share of the trust's current DNI. (IRC §662).

If US withholding tax has been withheld on US source income received by the trust, the beneficiary includes the withheld taxes in his/her income as a "gross-up " and claims a US credit for the proportionate amount of US taxes withheld. (Reg. 1.1141-3(f) and 1.1462-1(b)).

If the trust owes taxes to either:

1) The foreign country where it is organized, or

2) Another foreign country where it has makes investments,

it appears distributions to the US beneficiary would be grossed-up by the amount of tax paid to the foreign jurisdiction and the total reported as income. The beneficiary would then take a foreign tax credit for the amount of foreign taxes imposed, to the extent they are allocated to the beneficiary rather than to the trust. (IRC 642(a) and Revenue Ruling Rev 56-30).

Non-US Beneficiaries. A foreign beneficiary of a foreign trust is generally only subject to US income tax on the trust's US source income, and income "effectively connected with a US trade or business". The beneficiary is liable for US income taxes on current distributions on the lesser of:

1) The amount of income the trust actually distributes or is required to distribute to the beneficiary, or

2) the beneficiary's share of the trust's DNI.

With respect to US taxes withheld on payments to the trust, the foreign beneficiaries of the trust are entitled to credit for these taxes after grossing-up the taxes withheld and computing the tax liability on the distribution. (Reg. 1.1441-3(f); Reg, 1.1462-1(a) and (b)). Similarly the foreign beneficiary would be entitled to a credit for US tax withheld by the trust on the distribution to the beneficiary.

Accumulation Distributions (and Real Estate Sales by Canadian Trusts)

An "accumulation distribution" occurs when a trust distributes more than its current DNI, provided it has "undistributed net income" (UNI). Simplistically, UNI is the amount by which the trust's DNI in prior years exceeded the trust's actual and required distributions for those years, and the trust's income tax. (IRC §665). Accumulation distributions from domestic trusts are treated differently than accumulation distributions from foreign trusts.

A US beneficiary is subject to US income tax on all income distributed from the trust in an accumulation distribution, whereas a foreign beneficiary is only subject to US tax on distributions from the trust that are "US source income" and "income effectively connected" with a US trade or business.

A beneficiary receiving an "accumulation distribution" from a foreign trust is subject to the "throwback rule". The throwback rule computes the US tax on an accumulation distribution in five steps, after which an interest charge is imposed. The rule is designed to impose on the beneficiaries approximately the same income taxes that would have been levied if the trust had distributed its income in the year it was earned.

For US beneficiaries, the character of the income in an "accumulation distribution" is "ordinary income" without regard to the character of income in the year the trust realized it. In the case of a foreign beneficiary, the character of income in an accumulation distribution is retained in the hands of the beneficiary.

Thus, for example, if a Canadian uses a Canadian "discretionary" trust to purchase US real estate to avoid US estate tax, and the real estate is later sold at a profit with the proceeds being repaid to the Canadian, the Canadian may be deemed to have received "US source effectively connected income" from the trust, in which case there may be a US income tax filing required by the Canadian individual and he/she may have a personal US income tax liability on the gain. If the proceeds of the sale of the trust's property are not paid out in the year of sale, the Canadian recipient may be subject to the US rules for "accumulation distributions".

With respect to tax paid by the trust, a complicated set of rules in Code Sections 665, 666, and 667 describe how a beneficiary who receives an accumulation distribution of foreign source income on which the foreign trust has paid foreign income tax, must "gross-up" the amount of taxes deemed distributed, in his/her gross income. The beneficiary is then entitled to claim a foreign tax credit for the taxes deemed distributed.

HOW CANADIANS CAN AVOID US TAX WITHHOLDING - IRS FORMS W-8BEN, W-8ECI, 8233

The US tax rules generally require US tax to be withheld at source when US real estate is sold by a non-US person. Readers are aware of the "FIRPTA" withholding tax requirement on the sale of US real estate by nonresident aliens. Please see Exhibit 1. (Also please see the Fall, 2002, Taxletter. Call us for a free copy if you wish). Refer also to the current article ***"US REALTY SALES BY CANADIAN AND US PARTNERSHIPS AND LLCs".***

However US tax may be held in other circumstances as well. Some Canadians have had US tax inadvertently withheld on US bank interest or proceeds from the sale of US securities because they failed to provide adequate documentation to the US bank or stockbroker. We are aware of one nonresident alien whose US brokerage account was frozen for several months until he provided adequate documentation of his nonresident alien status to the broker.

Some Canadian businesses have been faced with potential US tax withholding on payments to them from US customers unless adequate documentation was provided to the customer.

Further, self-employed Canadians temporarily doing business in the US have occasionally have US tax withheld on payments to them.

What is going on here?

Canadians Receiving Interest and Dividends from US Banks and Stockbrokers

US banks and stockbrokers are required by the IRS to obtain the United States tax identification number of each of their clients, unless the client is a nonresident alien (or foreign corporation). If the client is a nonresident alien and does not have a US taxpayer identification number the client must certify his/her "foreign status" to the bank or stockbroker by executing and providing IRS Form W-8BEN to the bank or stockbroker.

For banks, it is normally sufficient for the client to complete only Part I (name and address) and Part IV (signature) of Form W-8BEN. This will exempt the client from US tax on any interest earned in the account. We have been aware of circumstances where the bank has also required a copy of the client's passport or other evidence that the individual was, in fact, a nonresident alien.

For stockbrokers, the client should also complete Part II (Claim of Tax Treaty Benefits) of Form W-8BEN. Part II is necessary if the client is purchasing US stocks that pay dividends and wants to rely that he/she will receive the lower treaty withholding rate on any dividends paid. In this case the individual should check line 9a in Part II and on line 10 would enter "Article X" and the appropriate withholding rate (15% for individuals).

Canadian Businesses Receiving Payments from US Customers

Canadians Not Engaged in US Business. No US federal income tax withholding is required on payments from a US customer to a Canadian enterprise if the Canadian enterprise is not engaged in business in the United States. Therefore if the US customer threatens to withhold on payments, the Canadian enterprise should attempt to convince the customer that the Canadian enterprise is not engaged in business in the US.

However since US customers are often nervous about their own potential contingent liability if they fail to comply with the rules, and since they will not normally be able to evaluate whether the Canadian enterprise is "engaged business in the United States" they will often:

1) Arbitrarily withhold tax, or

2) Ask the Canadian enterprise for its United States tax ID number, or

3) Ask the Canadian enterprise to provide them with one or other US tax form to avoid the withholding.

In these cases (where the income is received by a Canadian enterprise which is not engaged in US business), the enterprise should provide IRS Form W-8BEN to the US customer. This provides a basis to exempt the Canadian recipient from withholding. It will only be necessary to complete Parts I and IV since no treaty claim is necessary.

Canadians Engaged in US Business. We previously summarized some guidance on how you can evaluate whether or not your Canadian business is "engaged in US business". Please see the Fall, 2004, Taxletter.

If the Canadian enterprise *is* engaged in US business, then the appropriate form to provide to your US customer depends upon whether the Canadian enterprise has a US "permanent establishment" (PE).

If there is ***no*** PE, the Form to provide is W-8BEN and you complete Part II with respect to the treaty claim. (However some US customers may refuse to accept this, in which case you may be required to provide Form W-8ECI - see below). In either case there should be no withholding.

If there ***is*** a PE (or if there is no PE but your customer refuses to accept W-8BEN),

you should provide the US customer with IRS Form W-8ECI. This form will exempt the Canadian enterprise from US withholding on the basis that the Canadian enterprise will file a US income tax return. The US customer may require you to provide a US tax ID number with the Form W-ECI. This can easily be obtained in a matter of hours for a corporation.

Canadian Partnerships Engaged in US business

A Canadian partnership engaged in US business that receives income "effectively connected" with a US business should submit Form W-8ECI to the payer. It is not necessary for the partnership to attach to the W-8ECI all the forms W-BEN the partnership has received from its partners (see below).

Canadian Partnerships and Trusts Claiming Treaty benefits

A Canadian partnership (other than a hybrid entity) or trust not engaged in US business that receives US income and wishes to claim treaty benefits must provide IRS Form W-8IMY (Certificate of Foreign Intermediary etc.) to the payer.

Canadian Individuals Receiving Business Income Through a Partnership

If you are a partner in a US partnership that is distributing to you income that is "effectively connected" with US business, but not real estate rental income, you should provide IRS Form W-8BEN to the partnership. However, recall that the partnership itself is required to make quarterly tax payments to the IRS with respect to its "effectively connected taxable income" attributable to foreign partners. Please see the article ***"GENERAL WITHHOLDING RULES FOR FOREIGN AND DOMESTIC PARTNERSHIPS WITH NON-US PARTNERS".***

Canadian Individuals Receiving Real Estate Rental Income Through a Partnership

If you are receiving real estate rental income through a partnership and you want to make the "net election" on your personal tax return in the US to be taxed on a net basis, you provide Form W-8 ECI to the partnership instead of Form W-8BEN.

Individuals Receiving Income for Personal Services

A Canadian individual receiving compensation from US sources for independent (or certain dependent) personal services performed in the United States, should provide IRS Form 8233 to the payer, where appropriate, to avoid withholding.

Sale of US Real Estate

To potentially avoid or reduce US withholding tax at the time of a sale of US real estate you can consider whether you are eligible to file IRS Form 8288-B. Please see Exhibit 1, the Fall, 2002, Taxletter, and the current article ***"IRS TAXPAYER NUMBERS REQUIRED FOR CANADIANS FOR REALTY SALES AND WITHHOLDING APPLICATIONS".***

Due Diligence Requirements of the Payer

The above rules are enforced, in part, by the "due diligence" requirements imposed on the payer which may make it insufficient to simply provide the appropriate W-8 Form. For example, if you have an account with a US stockbroker that receives dividends from US corporations and you have a permanent address in the United States and/or mailing address in the United States the stockbroker may be required to obtain additional documentation (for example a passport or foreign drivers license) to substantiate that you are a foreign person.

US CITIZENS & GREEN CARD HOLDERS LIVING IN CANADA WITH MUTUAL FUNDS

We previously mentioned the US tax issues associated with US citizens and green card holders living in Canada, who own Canadian mutual funds. (Of course, the issues also apply to all US citizens and all US residents, with Canadian mutual funds).

These mutual funds are usually formed either as Canadian corporations or Canadian trusts. It is fairly settled that most publicly offered Canadian mutual funds that are organized as Canadian corporations constitute "passive foreign investment companies" (PFICs) for US income tax purposes. We previously described the potentially very adverse US tax consequences that can apply to the owners of those mutual funds.

Perhaps less settled is the US tax status of Canadian mutual funds that are organized as Canadian trusts. If these investments are considered trusts for US income tax purposes, an owner (who is a US citizen or green card holder living in Canada - or any US citizen or US resident) is subject to the trust reporting rules of IRS Form 3520 which we previously described. Substantial potential penalties can apply for failure to comply with the requirements of Form 3520.

On the other hand, if these investments are considered corporations for US income tax purposes, such an owner may be subject to the PFIC rules mentioned above.

Which is it? According to US tax regulations, the term "investment trust" is a trust created by several individuals in voluntary association as a means of pooling their capital for common investments in which interests are sold. These trusts can be classified as either true trusts or as corporations, depending on the number of classes of ownership interests created for the trust, and the breadth of investment and reinvestment authority granted to the trustee.

Generally, an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. (Reg. §1.7701-4(c)).

For circumstances where the IRS agreed that a trust was a "trust", see Revenue Ruling 73-460 and Revenue Ruling 75-192. For circumstances where the IRS decided that a trust was a "corporation" please see Revenue Ruling 78-371. Other guidance is provided in Revenue Rulings 2004-86, 79-77, and 89-124.

In cases where the managers of a mutual fund trust have the authority to "vary the investments" it appears such a mutual fund could be classified by the IRS as a corporation, and therefore a PFIC, instead of a trust for US tax purposes. Hence the potentially very negative US tax rules for PFICs could apply.

What are your alternatives if you own a PFIC?

Among other alternatives you can:

1) Continue to hold the investment in the regular way and comply with the negative tax rules at the time of sale,

2) Make at "QEF" election, or

3) Make a "mark to market election".

QEF Election

If you elect at the outset of your investment for the PFIC to be a "Qualified Electing Fund" (QEF) then, simplistically, the "bad" PFIC rules do not apply to you, and instead you will be taxed annually on your pro rata portion of the income earned by the PFIC. Unfortunately, the QEF election is not practical in many cases for investments in mutual funds because the information on your pro rata portion of the mutual fund's income is not easily available. Also see the rules for "pedigreed" and "non-pedigreed" PFICs.

Mark to Market Election

For many individuals who desire to own Canadian mutual funds "the mark to market" election can be the most practical alternative.

If you make the election and the fair market value of the mutual fund on the last day of the tax year exceeds its adjusted basis, then you include in your gross income for that year as ordinary income (not capital gain), the excess of the fair market value of the mutual fund over its cost base. (Reg. §1.1296-1(c)(1)).

If you make the election and the fair market value of the mutual fund on the last day of the tax year is less than its adjusted basis, then you have a capital loss in that tax year, unless you had prior "mark to market" ordinary income inclusions for that particular mutual fund. If you had such prior "mark to market" income inclusions for that particular mutual fund, then the current year's loss is an ordinary loss to the extent of such prior inclusions.

Thus an individual would not normally make an election until a year in which it would result in taxable gain (ordinary income). Once made, the election remains in effect for each succeeding year, unless it is revoked. Of course special rules apply if the stock ceases to be marketable, or the entity ceases to be a PFIC. The election can only be revoked with the permission of the IRS. (Reg. §1.1296-1(h)(3)(i)).

To make the election you must own the mutual fund on the last day of your tax year. (Reg. §1.1296-1(c)(1)). The election must be made separately for each mutual fund for which you want the election to apply. (Reg. §1.1296-1(b)(3)). The election must be made by the due date for the return (including extensions) on IRS Form 8621. (Reg. §1.1296-1(h)). Retroactive elections can possibly be made in accordance with Reg. § 301.9100. (Reg. §1.1296-1(h)(1)((iii)).

Transition Rule for Individuals Becoming Subject to United States Income Taxation

If a nonresident alien individual becomes a United States resident after December 31, 1997, the individual's cost base in the PFIC, for purposes of the "mark to market" election, may potentially be the greater of its fair market value or its cost base on the day the individual became a US resident. (Reg. §1.1296-1(d)(5)). This benefit only applies if a timely "mark to market" election is made in the first year of residency. (See Reg. §1.1296-1(d)(5) example).

Special Rule for Canadians Under Article XIII

Article XIII(7) of the tax treaty entitles certain nonresident aliens who moved to the US from Canada after September 17, 2000, to elect to use the fair market value of the mutual fund on the day they became a US resident as their cost base for mutual funds that were subject to Canadian departure tax.

UPDATE ON US DEPARTMENT OF COMMERCE FILINGS REQUIRED BY CERTAIN CANADIANS

We previously described the US Department of Commerce forms that must be filed when a Canadian individual or entity makes an investment in the US, including the purchase of rental real estate. Please see the Winter/Spring, 2008, Taxletter. Potential penalties up to $25,000 may apply for noncompliance.

These Forms include:

1) Form BE-13 or BE-13 Supplement C when the initial investment is made (but see below),

2) A quarterly filing of Form BE-605,

3) An annual filing of Form BE-15 (unless an exemption applies), and

4) A special "Benchmark" filing every 5th year on Form BE-12.

Beginning in 2009, for investments made after 2008, the Department of Commerce has discontinued the requirement to file Form BE-13 or BE-13 Supplement C with respect to the initial investment. This has been replaced instead with the requirement to file Form BE-605 quarterly.

Initial Investment

Thus, for US investments made after 2008, a Canadian individual or entity is not required to report the "initial investment".

Quarterly Filing

However the Canadian investor generally must file US Department of Commerce Form BE-605 quarterly for investments after 2008, including the purchase of US rental real estate or the formation or acquisition of a US business. The Form is due within 30 days of the end of the fiscal quarter (45 days if it is the end of the fiscal year).

Partial Exemption. There is a partial exemption with respect to the quarterly filing of Form BE-605 if all three of the following items for the US affiliate (the US investment) are $30 million or less:

1) Total assets,

2) Annual sales or gross operating revenues, and

3) Annual net income (loss) after provision for income taxes.

According to the instructions on the Form, in this case it is only necessary to complete the "Certification of Exemption" on page 13 of the Form and the signature on page 15 of the Form. However our experience is that on the first quarterly filing the Department of Commerce will contact you if you do not also complete line 10 on page 2. A separate instruction from the Department of Commerce requires you to complete pages 1 through 3, as well as pages 13 and 15.

After the filing of the first quarterly Form BE-605 "Certificate of Exemption", no further filing is required provided the US investment continues to meet the exemption criteria from quarter to quarter. (However the instructions state that you should nonetheless continue to file the "Certificate of Exemption" any time the Department of Commerce mails you a blank BE-605).

Annual Filing

The requirement continues, as before, for the annual filing of Form BE-15 after the end of each fiscal year. A simple Form "BE-15 Exemption Claim" can be filed instead, if all of the following are $40 million or less:

1) Total assets,

2) Annual sales or gross operating revenues, and

3) Annual net income (loss) after provision for US income taxes.

Following an initial filing of the BE-15 Claim for Exemption, it is not required again provided the investment continues to meet the exemption criteria. However the Department of Commerce states you must file the BE-15 Claim for Exemption again (assuming you qualify) if you receive a blank Form BE-15 from the Department of Commerce.

Quinquennial Filing

Every 5th year Form BE-12 Benchmark Survey must be filed. Form BE-12 Mini can be filed if the total assets, sales or gross operating revenues, and net income are less than $40 million. If those items are less than $15 million, only selected items on Form BE-12 Mini must be completed. The next benchmark survey will cover 2012 and will be conducted in 2013.

Penalties

Whoever fails to report shall be subject to inflation-adjusted civil penalties of not less than $2,500 and not more than $25,000. Whoever willfully fails to report can be fined not more than $10,000 and, if an individual, may be imprisoned for not more than one year, or both.

INDIVIDUAL STATE FILINGS FOR ESTATE TAX

In addition to the US federal estate tax law, many individual US states also levy estate tax. The Estate of every decedent who owned real estate located in such a State must obtain State tax clearance as well as federal tax clearance before the property can be sold.

In Florida, at present there is no estate tax but nonetheless there is a routine Florida filing requirement if a nonresident alien decedent owned Florida real estate. There are two different alternative Florida forms used for this, depending on the status of the decedent and whether or not a federal estate tax return is required.

1) A US Federal Estate Tax Return Is Required

Under 2009 rules, a US Federal estate tax return is required if:

a) the decedent is a US Citizen or US domiciliary and his/her total worldwide assets exceed $3.5 million, or

b) the decedent is a nonresident alien of the US and his/her total US situs assets exceed $60,000.

When a US Federal estate tax return is required, and the nonresident alien decedent owned Florida real estate, the estate should file Florida Form DR-313, "*Affidavit of No Florida Estate Tax Due When Federal Return Is Required*". The form is not filed with the State of Florida. It is simply recorded in the county records where the property was located. No filing is required with the State of Florida.

Therefore, in most cases where a Canadian passes away owning Florida real estate it will be desirable to file Florida Form DR-313 to facilitate any future sale of the property.

2) A US Federal Estate Tax Return Is Not Required

In cases where a federal return is not required (this will mostly apply only in the case of certain US citizens or US domiciliaries) a Florida filing should still be made if there is Florida real estate, or if the decedent was domiciled in Florida. In this case the appropriate Florida Form is DR-312, "*Affidavit of No Florida Estate Tax Due*". Again, it is recorded in the county records, it is not filed with the State of Florida.