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

IRS Suspends "FBAR" Reporting for Some Filers

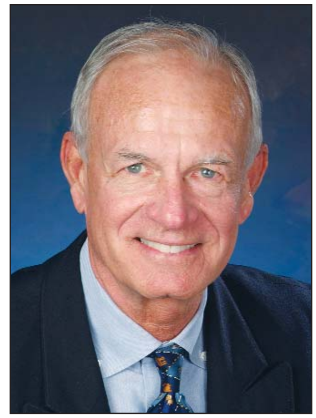
Apparently as a result of the complaints and confusion of taxpayers (and tax advisors), in June the IRS "suspended" the reporting requirement with respect to foreign accounts (Form TD F 90-22.1) for those persons who are not US citizens, US residents, or domestic entities. Please see the article ***"MORE ON "FBAR" NONCOMPLIANCE (REPORTING FOREIGN ACCOUNTS)"***.

New Expatriation Form Issued

The IRS has issued a revised IRS Form 8854, to be used by individuals who expatriate after June 16, 2008.

Airspace is Not a Foreign Country For US "Foreign Earned Income" Exclusion

A flight attendant was not permitted to consider income earned in international air space as income earned in a foreign country for purposes of the US "foreign earned income" exclusion, because airspace is not under the sovereignty of a Government other than the US. The flight attendant also was required to allocate unpaid pre-flight and post-flight service time when calculating foreign earned income, and to allocate income from sick and vacation leave between foreign earned income and income subject federal tax. (W.D. Rogers, TC Memo 2009-111).



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.

Kentucky Proposes Sales Tax on Digital Products

The Kentucky House of Representatives has passed Streamlined Sales and Use Tax legislation that would impose sales and use tax on sales and uses of digital products. The bill would impose a state sales tax on retail sales of digital property and use tax on use or other consumption in Kentucky of digital property. (HB 347 Feruary 26, 2009).

Washington State Sales Tax On Digital Products

The Washington Department of Revenue has issued a reminder that beginning July 26, 2009, sales or use tax applies to all digital products regardless of how they are accessed. The tax also apples to digital automated services and remote access software.

Vermont State Tax on Digital Products

On June 2, 2009, Vermont has also enacted legislation imposing sales and use tax on digital downloads.

Effective Date for Changes To Treaty Articles IV and V

On page 7 of the last (Winter/Spring, 2009, Taxletter) we inadvertently stated that

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new Paragraphs 7(a) and 7(b) of Article IV of the Treaty would be effective January 1, 2011. The correct effective date is January 1, 2010. Also, the effective date for the "permanent establishment" rule with respect to "services" is January 1, 2010. Please see the revised Exhibit 1.

Accrued Interest to Foreign Parent is Not Deductible

The IRS has concluded that the application of Reg. 1.267-3(a) to disallow deductions for interest accrued, but not paid, on notes payable to a taxpayer's foreign parent does not violate the nondiscrimination provision of the "applicable" tax treaty. (FAA 20090801F).

TSFAs Apparently Not Tax-Free in the US

The new tax-free savings accounts (TFSAs) available in Canada to allow Canadian taxpayers to earn tax-free investment income apparently are not tax-free in the US for a US citizen or US resident. Although the accounts are somewhat similar to Roth IRAs in the United States, unlike Roth IRAs, the tax treaty does not specifically designate TSFAs as "pensions", although the treaty gives the Competent Authorities the right to do so. Thus, for the moment, it appears the Article XVIII election to defer tax on TSFA's is not available in the US.

MORE ON "FBAR" NONCOMPLIANCE (REPORTING FOREIGN ACCOUNTS)

Readers are aware the IRS set a deadline of September 23, 2009, for noncompliant taxpayers to come forward and voluntarily file the "FBAR" (Form TD F 90.22-1 - Report on Foreign Accounts) and thereby reduce civil penalties and potentially avoid criminal prosecution for willful failure to file. As part of the program it appears the IRS will be cognizant of "silence compliances" - i.e. individuals who file amended US income tax returns to report previously unreported income associated with foreign accounts.

EXHIBIT 1

Effective Dates For Certain Treaty Changes (1)

	Effective Date
Interest Withholding At Source: – Zero Rate For Arm’s Length	February 1, 2008
Interest Withholding At Source: – 7% For Non-Arm’s Length – 4% For Non-Arm’s Length – 0% For Non-Arm’s Length	 January 1, 2008 January 1, 2009 January 1, 2010
Fiscally Transparent Entities Eligible For Benefits – Paragraph 6	January 1, 2009
Fiscally Transparent Entities Not Eligible For Benefits – Paragraph 7	January 1, 2010
Creating A Permanent Establishment Through Services	January 1, 2010
Election To Increase Cost Base On Emigration From Canada	September 18, 2000

(1) The 5th Protocol To The Treaty “Entered Into Force” December 15, 2008. Most Provisions Took Effect As Of January 1, 2009. However Some Provisions Have Other “Effective” Dates, As Set Out Here.

The recent intense focus by the IRS on compliance with the requirements for Form TD F 90.22-1 has triggered exposure of some dangerous side issues that may arise for individuals who fail to comply with the filing requirement.

For example, in one recent court case it was held that the FBAR penalties are not a "tax" or a "tax penalty" and therefore they are not discharged in bankruptcy. (Simonnelli, 102 AFTR 2nd 2008-6577 (D. Conn. Sept 30, 2008). In another recent case a taxpayer found that when he attempted to have the Tax Court remove the FBAR penalty, the Tax Court decided that it did not have jurisdiction to hear the case. (The rules for FBAR stem from Title 31 of the US Code, not Title 26 (The Internal Revenue Code). (J.B. Williams III, 131 TC No. 6 (Oct 2, 2008).

Another problematic situation may occur with US citizens or residents (or even Canadian snowbirds who meet the substantial presence test and fail to file IRS Form 8840 - Closer Connection Exception). The IRS has indicated generally that if you fail to file the FBAR, the penalties might not be imposed if you have reasonable cause provided all the income in the foreign accounts has been reported on your US income tax return and all the US tax has been paid.

Readers are aware that income earned or accruing inside Canadian RRSPs, RRIFS, and Canadian pension and profit sharing plans is taxable currently in the United States for such individuals if a tax treaty election is not made to defer reporting of the income. If individuals exclude such income from their US income tax return without making the election, and fail to file the FBAR, the automatic exemption from penalties may not apply. All the more reason for certain Canadian snowbirds to ensure they file IRS Form 8840. (Please see the article ***"REVIEW OF U.S. "RESIDENCY" RULES"***).

Who is Required to File the FBAR? More new Rules!

We previously described the new expanded rules with regard to who is required to file Form TD F 90.22-1. The new rules for 2009 (covering filings with respect to 2008) expanded the list of filers to include individuals and entities "in, and doing business in", the United States. Thus, certain Canadians who are nonresident aliens of the US and certain Canadian corporations would be required to file under the new rules.

However on June 6th the IRS announced in Announcement 2009-51 that it is suspending the filing requirement for Form TD F 90.22-1 (for the filing due June 30, 2009, only) for those persons (i.e. those individuals and entities) who are not US citizens, US residents, US partnerships, US corporations, or US trusts or estates. Thus the definition of who is required to file reverts temporarily to the "old" definition, meaning the filing is only required by US citizens, US residents, and domestic corporations, partnerships, trusts and estates.

CROSS-BORDER TAXATION OF CHARITABLE CONTRIBUTIONS

Among other circumstances, Canadian "snowbirds" visiting the US occasionally make contributions to US charities and US citizens resident in Canada make contributions to Canadian charities. Each country has its own set of domestic limitations on the degree to which a donation is deductible on an income tax return in that country. Among other factors, a deduction is normally available only if the charitable entity is a resident of that country.

The tax treaty (Article XXI) provides rules under which a contribution to a charity in one country may be deductible for income tax in the other country. The tax treaty rules do not override the regular domestic dollar value limitations in each country. Rather, they specifically allow a deduction for cross-border contributions and set additional limitations on the amount of deductions for those contributions. In addition the treaty provides general rules to define the type of entity for which a deduction is eligible.

Entities Eligible for Cross-Border Contributions

The treaty generally provides that an organization that is a resident of one country, that is generally exempt from tax in that country and could qualify in the other country as a registered charity if it were a resident of that other country, will be treated as a registered charity in the other country. Thus, contributions to religious, scientific, literary, educational, or charitable organizations that are recognized as tax exempt organizations and one country, are potentially eligible for charitable contribution deductions in the other country.

Limitation on Deductions for Income Tax

In the case of United States taxation, the contributions are not deductible in the US to the extent they exceed an amount determined by applying the normal domestic US limitations on charitable contributions to the income of the taxpayer arising in Canada.

In the case of Canadian taxation, the contributions are not deductible to the extent the tax relief would exceed the amount of tax relief that would be available under the Income Tax Act if the only income of the taxpayer for the year was the taxpayer's income arising in the United States.

However these restrictions do not apply in either country, in cases where the contribution is made to a college or university at which the citizen or resident, or a member of his/her family is, or was, enrolled.

Additional provisions apply. Please consult your tax advisor before taking any action.

An individual claiming a deduction on a U.S. income tax return for a donation to a Canadian organization must disclose the deduction on IRS Form 8833. A penalty of $1,000 may result for each Canadian donation that is deducted but not appropriately disclosed.

CANADIAN EMPLOYERS REQUIRED TO COLLECT US INCOME TAX ON WAGES?

Some Canadian employers may have a liability to collect US wage withholding income tax even though the employer has no office or assets in the US and possibly no employees working at any time in the US.

The US tax code requires "every employer" worldwide to collect US wage withholding tax on "wages" paid to all its employees, unless a specific exemption applies (IRC 3401(a)). Most of the exemptions stem from the limited definition of "wages". If the remuneration is excluded, under the tax code, from the definition of "wages", there is no wage withholding requirement. The penalties for late payment of wage withholding tax are quite severe.

The exemptions are listed in Code Sections 3401(a)(1)-(22). Some of them are mentioned below. But the rules are complex, please consult your tax advisor before taking any action:

Canadian Employers And US Citizens in Canada

Among other circumstances, "wages" do not include (i.e. there is no withholding), on the following:

1) Services performed if it is reasonable to believe that the remuneration will be excluded from gross income under Code Section 911 (the "foreign earned income" exclusion), (IRC 3401(a)(8)(A)(i)), (Note this does not apply to green card holders), or

2) Services that are performed in Canada if the employer is required by Canadian law to withhold Canadian income tax, (IRC 3401(a)(8)(A)(ii)), (Note this does not apply to green card holders - Reg. 301.3401(a)(8)(A)-1(b)), or

3) Services designated as "domestic service" in a private home, etc. (IRC 3401(a)(3)).

Separately, there is no withholding required for a pay period if the payroll period does not cover more than 31 consecutive days, and the portion of the remuneration that is not classified as "wages" under any of the rules of Section 3401(a)(1)-(22) covers less than half the payroll period. (IRC 3402(e)).

Canadian Employers and Green Card Holders Living in Canada

The tax code does not specifically provide for exemptions from wage withholding on US resident aliens, including green card holders living in Canada. Some of the exemptions available to US citizens do not specifically apply to resident aliens. For example there is a no exemption based on the "foreign earned income exclusion" or on the basis that the employer is required by Canadian law to withhold Canadian income tax.

Thus, for example, the Canadian employer of a green card holder who is resident in Canada could have an obligation to withhold US tax for work performed in Canada! The tax could perhaps be reduced to reflect the effect of foreign tax credits.

Canadian Employers and Nonresident Aliens of the US

The tax code states that "wages" do not include any remuneration paid to nonresident aliens that may be excluded under Treasury/IRS Regulations. (IRC 3401(a)(6)). Among others, the regulations exclude from the definition of "wages", (and therefore from withholding) the following:

1) Remuneration for services performed outside the United States,

2) Remuneration for certain transportation services and services on international projects (this does not apply to residents of Canada or Mexico who are employed only within the United States), and certification is required,

3) Remuneration which will be exempt from US income tax under the Internal Revenue Code, (see Code Exemption below, and

4) Remuneration which will be exempt from US income tax because of an income tax treaty, (See Treaty Exemption below. (Reg. 31.3401(a)(6)(-1)).

The other exemptions listed in Code Section 3401(a)(1-(22) are also available except to the extent they only apply to US citizens.

Also, Code Section 872(b)(3) provides for a federal income tax exemption for compensation paid to nonresident alien by foreign employers to employees holding and an F, J, or Q visa in the US.

Further, according to Code Section 3402(e) if the payroll period does not cover more than 31 consecutive days, and the portion of the remuneration that is excluded from "wages" under any of the rules of Section 3401(a)(1)-(22) covers less than half the payroll period, then there will be no withholding for that period).

Code Exemption - Short Term Business Visitors. The remuneration paid to a nonresident alien of the US by a Canadian business is exempt from US wage withholding (i.e. the remuneration is not classified as "wages" if three tests are met:

1) The nonresident alien is present in the US for 90 days or less during the year,

2) His/her compensation for the services does not exceed $3,000, and

3) The employer is not engaged in business in the US, or is not a US person with an office outside the United States.

(IRC 861(a)(3) and 864(b)1)).

Treaty Exemption. Article XV of the treaty provides that if a resident of Canada performs services in the US, the remuneration will not be subject to US tax (ie. will not constitute "wages" if:

(a) Such remuneration does not exceed $10,000, or

(b) The individual is present in the US for a period or periods not exceeding in the aggregate 183 days in that year and the remuneration is not borne by an employer who is a resident of the US, or by a permanent establishment which the employer has in the US.

(c) Notwithstanding the above, remuneration derived by a resident of Canada in respect of an employment regularly exercised in more than one country on a ship, aircraft, motor vehicle or train operated by a resident of Canada shall be taxable only in Canada.

Thus, for example, a Canadian employer that sends an employee to work temporarily in the US may have a US wage withholding obligation if the employer intends to deduct the wages from US taxable income, or if the employee is present in the US longer than 183 days.

CROSS-BORDER SPOUSAL GIFTS AND BEQUESTS

The increase in cross-border marriages (for example, second marriages of widowed snowbird retirees, first marriages of single residents of one country sent to work in the other country, or marriages resulting from acquaintances made on vacations to the other country) naturally creates cross-border tax complexities.

Gifts

Canada. - Canadians are aware if they give appreciated capital property to a spouse, the normal Canadian income tax "deemed disposition" rules may not apply (unless an election is made). Special computations may be required for depreciable property. (ITA 73).

However this exemption from the deemed disposition rules does not apply unless both spouses are residents of Canada at the time of gift. For example a gift of appreciated Canadian real estate or appreciated shares of a private Canadian corporation to a spouse may result in Canadian tax if the spouses are living in the United States. Of course special rules may apply in the case of a "principal residence". Please contact your Canadian tax advisor before taking any action.

US. - In the United States a deemed disposition does not apply on a gift to a spouse regardless of where the gift property or the spouses are located (absent unusual situations such as the gift of non-US property between nonresident alien spouses or the divorce of nonresident aliens owning US real estate). Readers are aware the US instead applies a "gift tax". The gift tax applies to the fair market value of the gift, not to the appreciation in value of the gift asset. Many exceptions and exemptions apply.

Any spouse (Canadian or US) can generally give anything of any value to a US citizen spouse without US gift tax, regardless of where the spouses live. (Some exceptions may apply, for example, in the case of terminable interest property).

On the other hand, when the gift is not to a US citizen spouse, there may be gift tax. Of course the IRS has no jurisdiction over a gift of non-US situs property between nonresident alien spouses. Also, a gift of a US situs intangible asset between nonresident alien spouses (for example US securities) is generally not subject to US gift tax. However the following spousal gifts to non-US spouses may trigger the gift tax rules (although there may be no actual gift tax because of the various exemptions):

1) Gifts between nonresident alien spouses of tangible US situs assets (for example, US real estate, or artwork or jewelry that is "domiciled" in the US),

2) The gift of anything by US citizens resident in Canada, and

3) The gift of anything by individuals domiciled in the United States.

In the case of gifts described in paragraphs 2) and 3) above there is a cumulative lifetime exemption of $1 million (2009). However, to the extent this exemption is utilized, it reduces the estate tax "exemption" ($3.5 million for 2009). These rules may change in 2010. Of course there is also a limited annual exemption on gifts to nonresident alien spouses.

Bequests

Canada. - As in the situation for gifts, the Canadian deemed disposition rule will generally apply for bequests of capital property between spouses unless the decedent spouse was a resident of Canada and the surviving spouse is a resident of Canada. (ITA 70). Please consult your Canadian tax advisor before taking any action.

US. - At the time of death the US imposes an estate tax rather than a deemed disposition tax. However, as in the case of gifts, a bequest to a US citizen spouse is exempt from US estate tax (subject to exceptions and exemptions, for example in the case of terminable interest property).

On the other hand, when a bequest is in favor of a non-US citizen spouse, there may be estate tax. Of course the IRS has no jurisdiction over the bequest of non-US situs property between nonresident alien spouses. However the bequest of US situs property between nonresident alien spouses is always "subject to" US estate tax. Of course even if the bequest is "subject to" US estate tax, there may not be any actual US estate tax, after the various rules and tax treaty provisions are taken into consideration.

"TIMELY-FILED" TAX RETURNS

In many cases, the penalties for late filing a US income tax return (even when no tax is due) have become outrageous. Witness, for example:

1) The $10,000 late-filing penalty for:

a) A Canadian corporation which has a US "reportable transaction",

b) A US Corporation 25% owned by a Canadian, which has a "reportable transaction", or

c) A US citizen or resident having a certain involvement with a Canadian private corporation or partnership, and

2) The potential imprisonment (in egregious circumstances) of a US citizen or resident who willing fails to file the FBAR report (Report on Foreign Bank and Financial Accounts).

Thus it is important to know what is meant by "late filing", and especially what it means with respect to tax returns filed from outside the United States.

According to Code Section 7502(a) the "date of delivery" of a tax return to the IRS is the "date of the United States postmark" stamped on the envelope, provided it is postmarked by the due date". Otherwise, the "date of delivery", for purposes of computing penalties, is determined by the date of the actual delivery to the IRS.

Code Section 7502(b) gives the US Treasury/IRS the authority to make regulations with respect to postmarks not made by the "United States Postal Service" (for example, foreign postmarks, postmarks of private US postage meters, electronic filing, private delivery services, etc).

Returns Filed by Surface Mail

1) Postmarked by US Postal Service. - Of course any tax return filed with a postmark from the US Postal Service by the due date of the return will be considered timely-filed. In many cases it will be desirable to mail the return by certified or registered mail.

2) Postmarked by Private Postage Meter. - Reg. 301.7502-1(c)(1)(iii)(B) addresses postmarks other than the US Postal Service. It provides that if a private postage meter mark lists the due date (or earlier), tax return will be accepted as timely filed if it is received by the IRS not later than the time when the tax return sent by the same class of mail, sent from the same location, would ordinarily be received by the IRS if it were postmarked by the US Postal Service on the due date. Of course in many cases it will be desirable to mail the return by certified or registered mail.

3) Private Delivery Service (PDS). - Code Section 7502(f) gives the Treasury/IRS authority to designate "Private Delivery Services" (PDSs) that will be treated as equivalent to the US Postal Service with respect to filing dates. A private delivery services is defined as any delivery service provided by a trade or business that is "designated" as such by the Treasury/IRS. Code section 7502(f) states that any reference to a "US postmark" will be treated as including reference to any date on which packages are delivered to a private "Designated Delivery Service".

The IRS has designated the following delivery services as PDSs:

1) For Federal Express, - the Priority Overnight, Standard Overnight, Second Day Service, International Priority and International First,

2. For United Parcel Service, - Next Day Air, Next Day Air Saver, Second Day Air, 2nd Day Air A.M., Worldwide Express Plus and Worldwide Express, and

3) For DHL Express, - Same Day Service, Next Day, and 2nd Day Service.

No other services offered by the above companies qualify for the timely-filing rule.

In many cases it will be desirable to obtain evidence of delivery to the PDS by the due date.

Foreign Postmarks

Although Code Section 7502(a) states the "date of delivery" of a tax return to the IRS is the "date of the United States postmark" stamped on the envelope, (provided it is postmarked by the due date), as indicated above Section 7502(b) gives the US Treasury/IRS the authority to make regulations with respect to postmarks not made by the "United States Postal Service".

No official regulations have been issued. However the IRS has issued a "Policy Statement" indicating that returns mailed by taxpayers from foreign countries will be accepted as "timely-filed" if they are officially postmarked in a foreign country on, or before, the return's due date. (Internal Revenue Manual 1.2.1.3.4. See also Revenue Ruling 2002-23 and CCA 200012085). Again it may be desirable to mail the return by certified or registered mail.

Electronically Filed Returns

Reg. 301.7502-1(d) provides that a document filed electronically with "an electronic return transmitter" can be deemed to be filed on the date of the "electronic postmark". Thus a return filed electronically directly with the IRS, or with a tax preparation service authorized by the IRS, will be considered timely filed if it contains a timely electronic postmark.

Hand Delivery

Of course returns may also be hand delivered to the IRS pursuant to Code Section 6091(b)(4).

SHAREHOLDER'S RULES FOR CFC's US COST BASE - & DIVIDEND TAXATION

US citizens and US residents who own private Canadian corporations (Controlled Foreign Corporations - "CFCs") must keep track of their cost base of the shares for US purposes because the corporation may ultimately be sold, liquidated, or make distributions in excess of its "accumulated earnings and profits". The cost base for US purposes will normally be different than the cost base for Canadian purposes. The US cost base will be affected, in part, by whether there has been section 951 income, and by dividends paid from such income.

Cost Base Rules for Your Shares in CFCs

Investment and Section 951 Income inclusions. For US purposes the cost base will naturally include amounts invested in the shares of the corporation, figured in US dollars as of the date of the investment. If the shareholder has been required to report income on his/her US income tax return as a result of Section 951 of the Internal Revenue Code (see the Summer, 2006, issue of the Taxletter), the amounts included in income under Section 951 will be added to the cost base of the shares. (IRC 961). Amounts included in income under Section 951 are translated into US dollars using the average rate for the year (IRC 989(b)(3) and therefore the same amount is added to the cost base of the shares.

Distributions. Simplistically, when distribution are received from the corporation the amounts will be allocated generally:

1) First to the aggregate of earnings and profits previously included in income under Section 951, and then

2) To other earnings and profits. (IRC 959(c))

To the extent the distributions are allocated to income previously included under Section 951 they will not be subject to tax to the shareholder (IRC 959(a)). However the amount so excluded will a reduction in the shareholder's cost base for the shares. (IRC 961(b)).

The amount by which the cost base is reduced is the amount of the distribution translated into US dollars at the date of the distribution (the "spot" rate). Any exchange gain or loss attributable to movements in the exchange rate between the date the earnings were included in income using the average rate (the Section 951 income rate) and the date the earnings are actually distributed, (the spot rate) is treated as ordinary income or loss to the shareholder.

If the distribution exceeds income previously taxed under section 951, it will be taxed to the shareholder as a "dividend" to the extent of any remaining "accumulated earnings and profits" in the corporation. This amount will be a translated to US dollars using the spot rate (the rate at the time of the distribution). (IRC 989(b)(1) and (2)). The amount will not affect the shareholder's cost base in the stock.

A distribution in excess of Section 951 income and accumulated "earnings and profits" will be a "return of capital" until the total exceeds the cost base of the shares. It is translated to US dollars using the spot rate at the time of the distribution. The shareholder's cost base in the shares is reduced by the same amount.

If the distribution exceeds the cost base, that portion will be a capital gain (IRC 961(b)(2)), computed by translating the amount received into US dollars at the spot rate.

Earnings and Profits

As indicated above, the concept of the corporation's "earnings and profits" is important because it has a bearing on how distributions to the shareholder are taxed. "Current" earnings and profits consist of the current taxable income with numerous potential adjustment for such items as accelerated depreciation, installment sales, income taxes, branch tax, and other factors.

THE US HAS ITS OWN "GST"! (GENERATION-SKIPPING TRANSFER TAX)

As part of its "US Estate and Gift Tax" laws, the US tax imposes a special "generation-skipping transfer tax" (GST) on transfers, whether outright or in trust, to a "skip person" - i.e. an individual who is at least two generations below the transferor's generation. The tax is a flat rate equal to the maximum estate tax rate (possibly 45%) at the time of the transfer, subject to a GST exemption amount.

For 2009 the GST exemption amount is $3.5 million and therefore in most cases the tax will only affect US citizens, certain green card holders, and US domiciliaries. A nonresident alien would usually only be affected when making a transfer to the "skip person" (by a gift or bequest) of US situs tangible property exceeding the GST exemption amount.

In the case of transfers to a trust, in general the transferor is the grantor of the trust to the extent the property transferred to the trust was subject to either a gift or estate tax to the grantor when transferred. Exceptions may apply. The tax may apply at the time of the "taxable termination" of the trust -- i.e. by death, lapse of time, release of power or otherwise.

The generation-skipping transfer tax is imposed in addition to any other applicable gift or estate tax. Thus, for example, a wealthy US citizen living in Canada who bequests more than the GST exemption amount to a "skip person" (whether by trust or otherwise), may be subject to both US estate tax and generation-skipping transfer tax as well as Canada's deemed disposition tax!

REVIEW OF U.S. "RESIDENCY" RULES

"Marvin is a U.S. resident!"

Readers are aware the word "resident" is used in many different contexts and has a different meaning in each. An individual can be a "resident" for many different purposes - e.g. U.S. immigration, U.S. income tax, U.S. estate (death) tax, individual US State income tax, health insurance, individual State real estate property tax exemptions, marriage and divorce law, and so on. Each has a completely different definition and meaning.

Residency for U.S. Income Tax Purposes

The United States does not have a "six months" rule. Instead, a non-US citizen is a U.S. resident for U.S. income tax purposes if the individual meets one of two tests:

1) The "green card" test, or

2) The "substantial presence" test.

(In certain cases an individual can also elect to be a US resident for income tax.)

Under the "green card" test, you are a U.S. resident for U.S. income tax purposes if you acquire "lawful permanent residence" in the United States under the U.S. immigration rules (i.e. you acquire a "green card") and you enter the U.S. after it is acquired.

The "substantial presence" test is an algebraic count of the number of days you spent in the U.S. over a three year period. To determine if you are a U.S. resident for the "current year", you compute the sum of:

1) The number of days present in the U.S. in the "current year", plus

2) One-third the days present in the U.S. in the preceding year, plus

3) One-sixth the days present in the U.S. in the second preceding year.

If this totals 183 days or more, and you spent more than 31 days in the U.S. in the current year, you will be a U.S. resident for the "current year" unless you qualify for the "closer connection" exception. (If certain filings are made, some people can ignore some of the days present for purposes the computation). To claim the "closer connection" exception you must file IRS Form 8840 by the deadline (assuming you are qualified to make the claim).

The "closer connection" exception does not apply to:

1) US citizens,

2) Green card holders, and

3) Other individuals, in a year in which they spend more than 182 days in the US during the calendar year.

Example: Michael is a semi-retired Canadian businessman/investor who is not a US citizen or green card holder. He spent winters in Arizona and Florida in 2006, 2007, and 2008. He also spent a month in Maine in the Summer of 2008 and spent two weekends in New York City in the Fall of 2008. As a result, he spent the following total amount of time in the United States.

2008	150 days
2007	115 days
2006	105 days

Did he meet the substantial presence test for year 2008? The formula is figured as follows:

All the days in 2008	150
1/3 the days in 2007	38 1/3
1/6 the days in 2006	17 1/2
Total	205 5/6

Michael Can Avoid Residency. Since the total equals or exceeds 183 days, Michael met the substantial presence test for year 2008. However this does not automatically make him a U.S. resident for 2008. He will not be considered a U.S. resident for income tax for 2008 if he files a valid "closer connection statement" (IRS Form 8840) by the deadline.

Michael Unable to Avoid Residency. If Michael fails to file Form 8840 by the deadline, he will be considered a U.S. resident for U.S. income tax purposes. (This does not give him the right to actually live in the United States. That right is only granted under the separate U.S. immigration laws).

Since Canada and the U.S. each have their own different (uncoordinated) tests for residency, each country's residency test operates independently from the residency test in the other country. So it is possible for Michael to meet both country's tests, and thus be considered a resident of both countries simultaneously (i.e. a dual resident).

What happens then?

Michael has 2 options in the US.

1) He can file a resident income tax return in both countries (IRS Form 1040 in the US) and report his worldwide income on both country's tax returns. Normally, (but not always), there will be no double tax because of the rules for deductions for "foreign tax credits" under each country's domestic law.

However, there *are* cases in which there could be unexpected tax. For example the United States does not have the exact equivalent of Canada's partial exemption on the gain from the sale of a private business, and the rules for the exemption from gain on the sale of a "principal residence" are also different in each country. Accordingly that type of income (for example) could be taxable in the United States for Michael (or certain other Canadian snowbirds who fail to timely-file a required Form IRS 8840).

2) Alternatively, Michael can claim US benefits under the tax treaty's "residency tie-breaker rules". This may allow Michael (a dual resident) to compute his income tax liability as a resident of one country and a non-resident of the other. (There is apparently a difference between the US and Canadian interpretations of this portion the tax treaty. In the US, the treaty claim is optional. In Canada, apparently the Canada Revenue Agency can unilaterally determine your residency under the provisions of the treaty).

BEWARE! In the US, the tax effect of the residency tax treaty claim is unusual. If Michael makes a claim under the treaty "residency tie-breaker rules" to be taxed as a non-resident of the United States, this claim only has an effect for purposes of allowing him to compute his US income tax liability.

Strangely, Michael is still considered a US resident for all other purposes of the Internal Revenue Code. For example, Michael must comply with a myriad of U.S. reporting requirements, many of which may result in significant penalties if he does not timely comply. Readers are aware this may result in a $10,000 penalty for each of his private Canadian corporations and/or partnerships, and penalties of $10,000 and up, for failure to file the FBAR (Report on Foreign Financial Accounts).

Residency for U.S. Immigration Purposes

Permanent Residency. For a non-US citizen the only way an individual can immigrate into the US is to obtain a "green card". Such an individual is referred to as a "lawful permanent resident" of the US. He/she has most (but not all) of the rights of a US citizen. (Federal voting rights may not exist, and the individual may not be subject to jury duty). In most cases the individual can live and work in the US indefinitely. A special class of green cards (Category EB5) allows an individual to, effectively, "purchase" a green card.

Work and Investor Visas. The US has other visas that are referred to as "non-immigrant visas". These visas allow an individual to live and work in the United States for the period covered by the visa. For example, the visa may run for a time period from 1-5 years. Thereafter, when the visa expires, the individual may be required to leave the US, although in many cases the visa can be renewed. Some examples of commonly acquired visas are TN (Trade NAFTA), H1B (Employee), L1 (Intercompany Transfer), and E2 (Treaty Investor).

Residency for U.S. Estate Tax Purposes

Although the estate tax laws use the word "residency for US estate tax purposes" the expression commonly used for such residency is "domicile" to avoid confusion with the income tax rules. An individual who is not a US citizen is still subject to US estate tax on his/her worldwide assets if he/she is "domiciled in the United States".

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

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

1) The individual must live in the US, and

2) He/she must intend to remain in the US indefinitely.

Both elements must be present to establish a new domicile.

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

For more on domicile please see the article on page 2 of the Winter/Spring, 2007 issue of the Taxletter (***"ARE GREEN CARD HOLDERS SUBJECT TO US ESTATE TAX ON EVERYTHING?"***).

IMPORTANT OWNERSHIP ATTRIBUTION RULES FOR IRS FORMS 5471 AND 8865

US residents (including green card holders living in Canada) and US citizens (including those living in Canada) must file IRS Form 5471 or 8865 if they have a certain involvement with a private Canadian corporation or partnership. The requirement may apply, among other circumstances, if they have a certain degree of ownership in the entity. The penalty for failure to timely comply can be $10,000 or more.

However it is often difficult to determine if the individual meets the ownership filing requirements!

To determine if you must file based on ownership requirements it is necessary to analyze what you own directly but also what you own indirectly, and what you are deemed to own because it is owned by individuals or entities with which you have a prescribed relationship. The latter is referred to a "constructive" ownership. If you have a "constructive" ownership interest in a corporation or partnership you may be required to file Form 5471 or 8865, as the case may be, even if you do not have a direct or indirect ownership interest.

Code Section 318 contains general rules for constructive ownership that are modified in certain cases when they are applied to the reporting requirements for Forms 5471 and 8865.

Members of a Family.

Under Section 318(a)(1) an individual is considered as owning stock owned (directly or indirectly) by the individual's spouse, children, grandchildren, and parents. There are special rules for adopted children and separated spouses.

Attribution From Entities. Section 318(a)(2) sets out rules for circumstances when stock owned by corporations, partnerships, estates, or trusts, will be considered owned by their shareholders, partners, or beneficiaries, as the case may be.

For example, in general, stock owned directly or indirectly by a trust is considered owned by the trust's beneficiaries in proportion to the beneficiary's actuarial interest in the trust.

Attribution To Entities. Section 318(a)(3) provides the rules under which stock owned by shareholders, partners, or beneficiaries, of corporations, partnerships, trusts, or estates, will be considered owned by the related corporation, partnership, trust, or estate.

Special rules are provided for stock options.

One of the most common cross-border circumstances involving constructive ownership may occur when a US citizen resident in Canada, is married to a Canadian nonresident alien of the US who owns a Canadian private corporation. Because of the constructive ownership rules described above under "Members of Family", the US citizen spouse may be considered to own the shares of the Canadian private corporation owned by his/her Canadian spouse. Therefore, even if the US citizen owns no shares in a Canadian corporation, that spouse may still be required to file IRS form 5471 with respect to changes in the other spouse's shareholdings of the Canadian corporation. (Category 3. filer for Form 5471).

However the rules for attribution from spouses is overridden in the case of Category 4. and Category 5. filings for Form 5471 (Categories for "Control" of the corporation, and "Controlled Foreign Corporation", respectively).

For Category 4. filings there is no attribution from a nonresident alien spouse if the other spouse (the US citizen spouse in our case) does not own any direct or indirect interest in the corporation. (Reg. 1.6038-2(l)).

For Category 5. filings there is no attribution from a nonresident alien spouse to a US citizen spouse even if the US citizen spouse does own some shares in the corporation. (Reg. 1.958-2(b)(3)).

Many other complex attribution rules apply. Please consult your tax advisor.

INTERESTING TAX DEDUCTIONS!

By Robert S. Blumenfeld, Esq., (Tax Attorney) tel. 954-384-4060.

Each year when taxpayers realize how much money they will have to send to the United States Treasury Department/IRS, some become inspired and think of new and in genious ways to claim deductions which will ultimately result in a lower tax for the year. Many of these ideas do not pass the scrutiny of the Internal Revenue Service, but a few sneak by. Some of these attempts at taking deductions are somewhat amusing.

In my years at the Internal Revenue Service, the most ingenious idea that I saw was one attributable to a doctor. As many of us know, if we buy certain assets (a computer, printer, even a building) which is used in the "production of income", we are entitled to deduct it, or depreciate it over a number of years. This doctor decided that his brain was such an asset and attempted to depreciate it. He felt that his basis in the brain (the cost which is the basis of depreciation) was linked to the cost of his undergraduate and medical school education. The IRS (and the Tax Court), although they felt that it was a good try, did not allow the deduction. They felt that any person who worked would be able to claim this deduction, and it would set a terrible precedent.

A gas station owner whose business was very slow decided to give a sixpack of beer to each customer who purchased gasoline in excess of a certain amount. He attempted to deduct the cost of the beer as a business expense. The court was sympathetic, and he was granted the deduction. Contrast this with a businessman who attempted to give his customers cases of whiskey and deduct the cost as a business expense. "No way" said the court. Generally gifts to customers are deductible up to the amount of $25 per client. If you exceed $25, zap!

A Pennsylvania businessman owned a store which was not faring very well. His attempts to sell it were similarly unsuccessful. He then paid someone $10,000 to torch the building. He collected the insurance but on his income tax return, attempted to take the $10,000 paid to the arsonist as a deduction! Not only did the IRS disallow the deduction but reported it to the proper authorities, and both the store owner and the arsonist ended up in the slammer.

We all would love to go to the Super Bowl. We would like it even more if someone underwrote our expenses. And so it was that a businessman took several of his best customers to a Super Bowl and deducted all the expenses on his income tax return. Apparently he forgot to invite the judge who disallowed the deduction. The basic reasoning was that there was no way that these gentlemen could have discussed business during the Super Bowl game, a prerequisite to being able to claim such an expense.

A businessman owned a dog which apparently became very lonely when left alone during the day. The gentleman hired someone to spend the day with the dog and then attempted to claim a day care tax credit for the expenses of the dog sitter. Alas, the credit is limited to children and legal dependents, which the dog was not, and so the credit was disallowed.

A businessman owned a junkyard which was plagued by rats. Several wild cats began living in the junkyard and dining on the rats. When the number of rats was severely diminished and the cats could not get enough nourishment, the owner began leaving out bowls of food to encourage the cats to stick around and control the rat populace. The IRS agreed the cost of the food for the cats was deductible as a business expense.

Many of us would like to have a swimming pool but cannot afford it without a heavy subsidy. A person who had asthma was told by his doctor that he should have a swimming pool in which he could exercise and fortify his lungs against this disease. He then deducted the cost of the swimming pool, chemicals, and services on his tax return. The IRS allowed the deduction as a "necessary medical expense".

The most entertaining deduction I have ever seen was claimed by an exotic dancer who claimed as medical expenses the costs of breast augmentation. The IRS disallowed the deduction. But the court disagreed! The court felt that this expense was ordinary and necessary in this young lady's profession and so allowed the deduction!

Perhaps this article, will inspire the creative abilities of some of my readers. In some cases your inspiration may not be too far-fetched!

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STOCK OPTIONS AND CROSS-BORDER TAXATION

Gain earned by an employee from the exercise of nonqualified (nonstatutory) stock option is normally taxed as "compensation". Similar rules apply to a qualified stock option or incentive stock option if there is a "disqualifying disposition". Therefore special cross border compensation "source" rules are required for the taxation of such income when the employee works in more than one country while the options are outstanding - i.e. after they have been granted but before they have been exercised.

For example, a Canadian employee (nonresident alien of the US) may be granted nonstatutory stock options in his/her Canadian employer/corporation while working in Canada. After the option is granted, but before it is exercised, the employee may be transferred to the US subsidiary or parent of the Canadian corporation. Which country is entitled to the primary tax on the gain on the Canadian stock options once the option is exercised?

Case #1 - US Residents (including US Citizens) at Time the Option is Exercised

If the individual is classified as a US resident at the time the option is exercised, the entire gain (the spread) is subject to tax in the United States. (Stanford v. Commissioner 297 F.2nd 298, 304).

However a portion of the gain is subject to tax (as compensation) in Canada. The portion allocated (sourced) in Canada will be in the same proportion of the gain that the number of days between the time the option was granted and the time it was exercised (or disposed of) on which the individuals principal place of employment for the employer was in Canada, is of the total number of days in the period on which the individual was employed by that employer. (See paragraph 6(a) of the Diplomatic Notes to the Fifth Protocol (Appendix B). An exception may apply under paragraph 6(b)).

In this case, Canada will be entitled to the first tax on the portion of the gain sourced in Canada, and although the entire gain must be reported in the US, a foreign tax credit will be available on the US tax return for all or part of the tax paid to Canada on the gain.

Example: Harry (a nonresident alien of the US) moves to the US to work for the US subsidiary of his Canadian employer. After being resident in the US for awhile he exercises options in the Canadian corporation that he was granted while he was working for the corporation in Canada. There were a total of 800 days between the time the options were granted and the time they were exercised (the "period"). During that time (the "period") Harry's principal place of employment was in Canada for 200 days, and in the United States for 600 days. Therefore one quarter of the gain will be taxed in Canada, and all of the gain will be taxed in the United States, but the United States will give a foreign tax credit for all or part of the tax paid to Canada on the gain allocated to Canada.

Of course similar results would apply if a US citizen initially worked in Canada for a Canadian corporation and subsequently moved to the United States, after which the options were exercised. In this case a portion of the gain attributable to Canadian employment might be eligible for exclusion from US tax under the "foreign earned income exclusion" provisions.

Case #2 - Canadian Residents (Nonresident Aliens of the US) at The Time the Option is Exercised

If the individual is classified as a resident of Canada and a nonresident alien of the US at the time the option is exercised, the entire gain (the spread) is subject to tax in Canada. However a portion of the gain is subject to tax (as compensation) in the United States. The portion allocated (sourced) in the US is determined in accordance with the same allocation rules described above. The US will be entitled to the first tax on the gain allocated to the US, and Canada will give a foreign tax credit for all or part of the tax paid to the United States.

Case #3 - Canadian Residents That are US Citizens at The Time the Option is Exercised

In this case the entire gain must be reported in both countries. However the computation of foreign tax credits on both the Canadian and US income tax returns may be complex because of the circularity of the foreign tax credit computations under the tax treaty.

The US rules for the actual taxation of stock options and other stock plans can be complex due, in part, to the number of different type of plans. We will review some of the rules for the taxation of stock options and stock plans in the next Taxletter.

US ESTATE TAX PLANNING FOR NONRESIDENT ALIENS WITH "CHECK-THE-BOX"

As a result of changes in the US domestic law and the tax treaty, US estate taxes have acquired reduced significance when buying US real estate (or other US assets) for many Canadians that are non-resident aliens of the US.

However for some wealthy Canadians making a substantial US real estate investment, the estate tax is still a matter of concern.

Some Canadian tax advisers have recommended that such Canadians consider the use of a Canadian trust to purchase US real estate. We previously mentioned some of the caveats with respect to this procedure. Another alternative is the use of a Canadian partnership, as summarized below.

Readers are aware that the acquisition of US real estate directly and initially by a Canadian corporation will generally protect the Canadian shareholder from US estate tax on the corporation's US property provided the corporation is properly operated. Of course there may be negative Canadian tax consequences to such a structure - please consult your Canadian tax advisor before taking any action.

One drawback to corporate ownership, is the potentially higher US income tax rate on gains from the sale of the US real estate that applies to corporations, compared with the tax rate that applies to individuals and trusts. From a US income tax perspective, and perhaps from a worldwide aggregate US/Canadian income tax perspective, it is preferable if the property is owned by an individual, (or individuals) or through a flow through entity, such as a partnership, whereby gain is only taxed once, at the individual level.

For example, if a Canadian partnership owns US real estate, any gain on the sale of the real estate is generally only taxed at the partner level in the US and Canada, with the possibility of full credit in Canada for taxes paid to the United States. But as indicated in prior Taxletters this structure might subject a Canadian partner to US estate tax, if one should die prior to the sale of a property.

However a Canadian partnership is generally entitled to make a "check-the-box" election in the United States whereby the partnership is treated as a corporation for US tax purposes. Thus, if US real estate were purchased by a Canadian partnership, and a partner died, some may argue there would be no estate tax if the partnership had made a check-the-box election, because the property would then be considered owned by a Canadian corporation. As indicated above, ownership by a Canadian corporation may protect the owner/partner/shareholder from US estate tax. Thus, in theory, Canadians that are nonresident aliens of the United States could:

1) Purchase US real estate through a Canadian partnership, and

2) If the property remains unsold when death of a partner appears imminent, the partnership could arrange for the check-the-box election to attempt to avoid US estate tax.

The individual would then potentially have the best of both worlds - low US income tax on the gain on the sale of the US property and no US estate tax in the event of death before the sale. Of course, as usual there are many caveats, and some are mentioned below.

As a practical matter, it may not be realistic to anticipate death and/or given the emotion of the moment, US estate tax planning may not be foremost on everyone's mind. Thus the election may be overlooked and the death may occur prior to the election having been made. Fortunately the US rules permit the election to be effective up to 75 days prior to the date the election is made. As long as the election is made within 74 days of the date of death the plan may protect the decedent from US estate tax.

Will it work?

Just as difficulties can be found with the use of certain trusts for US estate tax protection, difficulties can be found with the partnership/check-the-box procedure as well.

It is recalled that although the original direct purchase of US real estate by a Canadian corporation will likely protect the shareholder from US estate tax, the IRS will clearly levy the estate tax on a deceased shareholder of a Canadian corporation that owns US real estate which was transferred into the corporation from the shareholder himself (assuming the IRS becomes aware of the death and the transfer). Although the IRS makes this assertion pursuant to Code Section 2036 (Transfers with Retained Life Estate) and/or Section 2038 (Revocable Transfers), some tax commentators dispute the right of the IRS to do so. We are unaware of it having been tested in court.

When a partnership converts to a corporation, the IRS might treat the partnership as being dissolved and its assets treated as transferred to the corporation by the partners. Therefore if the IRS becomes aware of the death and the check-the-box transaction the IRS might still attempt to levy estate tax on the basis of Code Sections 2036 and/or 2038. See also Code Section 2104(b).

Also, if the IRS treats the property as being transferred from non-US persons (the partners) to a foreign corporation the transaction will trigger US income tax on the gain, if any, on the disposition - i.e. generally on the amount by which the present fair market value of the property exceeds the partner's cost base. If the transaction is taxable the US "FIRPTA" withholding tax applies - i.e. within 20 calendar days of the effective date of the election, 10% of the fair market value of the property must be remitted to the IRS as a prepayment on any applicable income tax. If that date has passed, penalties for late compliance may apply.

USING "BYPASS" TRUSTS FOR US ESTATE TAX PLANNING FOR NONRESIDENT ALIENS

A structure that is commonly used among US citizen spouses to avoid, or reduce, US estate tax, may be applicable in some cases for a Canadian decedent who is a nonresident alien of United States.

Subscribers are aware:

1) For the year 2009 there is, effectively, a $3.5 million exemption from US estate tax for decedents that are US citizens or US domiciliaries, and

2) There is an unlimited exemption from US estate tax on assets passed to a US citizen surviving spouse (provided it is not terminable interest property).

In cases where the aggregate worldwide assets of both spouses do not exceed $3.5 million there will be no estate tax in 2009, even if both spouses pass away in 2009, because the assets of neither decedent will exceed $3.5 million at the date of death, even if one spouse inherits the other's assets before dying.

When the aggregate worldwide assets of the spouses do exceed US $3.5 million, US tax advisers often recommend that US citizens provide for a "bypass" or "credit shelter" trust to reduce US estate tax.

Standard US Domestic Circumstances - Both Spouses are US Citizens (Rules for 2009)

In a "standard" domestic US situation where both spouses are US citizens, each spouse's Will may contain a provision for:

1) A "bypass" or "credit shelter" trust, and

2) A marital trust.

Expressed simplistically, the Will of the decedent would provide that the first $3.5 million of the decedent's assets pass to a "credit shelter" trust and the balance would go to a "marital" trust. There would be no tax on the $3.5 million going to the credit shelter trust because of the $3.5 million exemption, and there would be no estate tax on the assets going to the marital trust, because of the unlimited marital deduction available to a US citizen surviving spouse.

For this planning to succeed the "credit shelter" trust must contain restrictions on the surviving spouse's access to assets in the trust. This trust generally gives the surviving spouse an income interest for life, and a right to receive principal in accordance with the trustees' discretion, subject to an ascertainable standard. Thus $3.5 million can bypass the surviving spouse's estate, (even though he/she receives the income from it).

Upon his/her death the surviving spouse will also be entitled to the $3.5 million exemption on the assets in the marital trust. Therefore a total of approximately $7 million can be passed to heirs without US estate tax. Of course if the aggregate spousal assets do not exceed $7 million, it is not necessary to put the full $3.5 million in the "credit shelter trust". It may not even be necessary to place the assets otherwise going to the marital trust in an actual trust.

Cross Border Circumstances - Both Spouses Are Nonresident Aliens of the US (Rules for 2009)

When a decedent who owns US property is not a US citizen (or domiciliary) and the surviving spouse is not a US citizen, (and therefore is not entitled to the unlimited marital deduction) the estate is nonetheless entitled to a US unified estate tax credit under the tax treaty, (and a marital estate tax credit under the tax treaty to the extent the US situs property of the decedent passes to the surviving spouse).

Very simplistically,

1) Because of the tax treaty there will generally be no US estate tax if a Canadian passes away with worldwide assets not exceeding approximately US $3.5 million, and

2) Also simplistically, because of the tax treaty there will be no US estate tax on the first death if the aggregate worldwide assets of the two spouses do not exceed approximately $7 million, and all the US assets pass to the surviving spouse.

However if the aggregate worldwide assets of the spouses exceed US $3.5 million and the assets of the deceased spouse go to the surviving spouse, there could be estate tax on the US assets at the time of the surviving spouse's death because the worldwide assets of the surviving spouse would then exceed US $3.5 million.

Therefore in cases where the aggregate assets of the spouses exceed a subjectively determined amount (for example US $3.5 million) it may be appropriate to consider providing for some form of Canadian counterpart to a US "bypass trust" in the Will of each Canadian where necessary, or relevant, for US estate tax planning.

In a simple example, if the aggregate worldwide assets of the Canadian spouses with US property were US $7 million (solely owned US $3.5 million in each spouse's name) it may be advantageous to plan for the assets of the first to die to pass to a Canadian trust instead of directly to the surviving spouse. The income from the trust is allowed to go to the surviving spouse. Provided the rules of the Canadian trust conform to the "credit shelter trust" rules in the US there may be no US estate tax on the death of either spouse because the worldwide assets of neither would exceed US $3.5 million. Of course Canada's "deemed disposition" rules on death must be considered. Please consult your Canadian and US tax advisors before taking any action.

The above general rules are applicable only for 2009. It is uncertain what rules will apply after 2009.

CAUTION FOR US CITIZENS IN CANADA INVESTING IN CANADIAN BONDS

We previously summarized some rules in connection with currency translations and exchange gains and losses. (e.g. please see the Fall, 2008, Taxletter).

Surprising results may occur, for example, if a US citizen or green card holder makes an investment in Canadian bonds denominated in Canadian dollars. Such a transaction would normally be considered a "Section 988 transaction" under the Internal Revenue Code. Therefore any currency gain or loss on the ultimate disposition (or maturity) of the bonds would be taxed in the US as ordinary gain or loss (not capital gain or loss). Therefore the tax on any gain would not be limited to the 15% maximum capital gains rate (for property held over 12 months) but would be taxed at rates up to the maximum rate (currently 35%).

On other hand, if an exchange loss is incurred on the sale of the bonds it is an "ordinary loss" which is potentially deductible against other income such as salaries and investment income.

Example: Sam (a US citizen living in Canada) purchased Canadian Government bonds for CAD $500,000 when the exchange rate was $1 CAD = .$80 USD. Fifteen months later, (during which time interest rates remained exactly the same) Sam sold the bonds for CAD $500,000 when the exchange rate was $1 CAD = .$90 USD. Since Sam earned a USD $50,000 exchange profit on the sale, he must include $50,000 ordinary income on his US income tax return, even though there was no gain at all for purposes of his Canadian income tax return.

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