BRUNTON'S

U.S. Taxletter

FOR CANADIANS

Covering U.S. Aspects of U.S. Citizens or U.S. Residents with Canadian Income or Assets, and Canadians with U.S. Income or Assets

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ADMINISTRATIVE/LEGISLATIVE/ JUDICIAL UPDATE

US Estate Tax Update

The US estate and gift tax rules for 2010 are still unresolved as we go to press. We will send a "US International Tax Alert" by email when legislation is approved by Congress. (You can sign up for free "US International Tax Alerts" at our website.

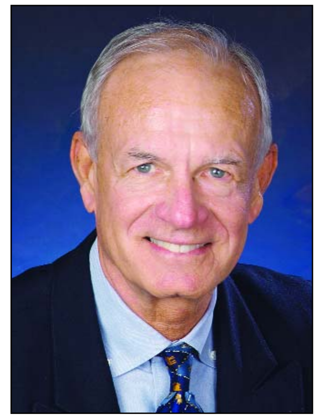
Strangely, Internal Revenue Code Section §6018 still requires a "return" to be filed for 2010 in the case of the estate of any nonresident alien whose US property exceeds $60,000.

Nexus in Michigan

A Michigan court recently concluded that Michigan business tax was payable by an out-of-state corporation because the out-of-state corporation had <u>independent registered representatives</u> (IRRs) doing business as agents of the corporation acting on its behalf to solicit requests for securities transactions within Michigan.

The Michigan Court of Appeals concluded that the IRRs activity constituted nexus because the contractual relationship between the IRRs and the out-of-state corporation resulted in the <u>physical presence</u> in Michigan of a person doing business in Michigan on the out-of-state corporation's behalf. (Vestax Securities Corp. v. Department of Treasury, Michigan Court of Appeals, No. 292062). Would this also apply to an out-of state (Canadian) corporation seeking business in Michigan via independent agents?

Canadian Taxation of US Roth IRAs



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 39 YEARS.

In Notice 43 (September 24, 2010,) the Canada Revenue Agency (CRA) issued some extensive rules in connection with the Canada taxation of US Roth IRAs. For the moment, a Roth IRA is not a "foreign retirement arrangement" for purposes of the Canadian income tax.

The taxation in Canada is dependent upon whether the particular Roth IRA is a "custodial account", a trust, or an annuity contract or endowment contract from a life insurance company.

However if a resident of Canada wishes to defer Canadian taxation (under the treaty) on income accrued in a Roth IRA after December 31, 2008, the individual should file a one-time irrevocable election in respect of each Roth IRA plan or account. There is no official form to make the election. It should be made in the form of a letter. Notice 43 sets out the information required and the address to which the letter should be mailed.

Notice 43 also states that a Canadian resident individual <u>may be required to file Canadian tax Forms</u> T1135, (Foreign Income Verification Statement), Form T1141 (Information Return Re Transfers or Loans to a Nonresident Trust), and/or T1134-B (Information Return Re Controlled Foreign Affiliates) <u>each year</u> in respect of the Roth

IRA. Of course penalties may apply for noncompliance.

The Notice also sets out important deadlines for making the election. Please consult your tax advisor quickly.

Notice 43 further notes that draft legislation was released August 27, 2010, which would amend the rules covering nonresident trusts and the related foreign reporting rules.

Nexus in New York

A New York court has determined that an out-of-state corporation was subject to income tax in New York even though it was a holding company and was not licensed to do business in New York. Under New York law, if a partnership is doing business in New York all corporate general partners are subject to New York tax under New York law. It was determined that the out-of-state corporation was a corporate general partner of a partnership doing business in New York, and thus had sufficient nexus to be taxed. (Shell Gas Gathering Corp. #2, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA numbers 821569 and 821570).

Nexus in Ohio

The Ohio Department of Taxation determined that an out-of-state corporation was subject to Ohio commercial activity tax (CAT) because it had nexus in Ohio as a result of having annual gross receipts of at least $500,000 in Ohio (the "bright line" test). (L. L. Bean Inc., Ohio Department of Taxation, August 10, 2010).

Some US Inflation-Adjusted Figures for 2011

The IRS has announced several inflation-adjusted figures for 2011. A few of these that relate to cross-border situations are as follows:

Expatriation Exemption under Code Section 877A - $636,000.

Foreign Earned Income Exclusion - $92,900.

General Gift Tax Exclusion - $13,000.

Gift Tax Exclusion to Nonresident Alien Spouse - $136,000.

US "Tax Preparer" ID Numbers And New York

It has been well publicized that beginning January 1, 2011, any tax preparer who prepares even one US federal tax return for a fee must have a US Tax Preparer Identification Number. ("PTIN"). A "tax preparer" is defined as "*any individual who is compensated for preparing, or* ***assisting in the preparation of****, all or substantially all of a tax return or claim for refund. A tax preparer also includes an individual who is a non-signing tax return preparer as defined in Reg. §1.301.7701-15(b)(2) or an individual described in Regulation §301.7701-15(f).* (Emphasis supplied).

Now the State of New York has reminded tax return preparers that they may be required to register with the New York Department of Taxation and Finance. (New York Department of Taxation and Finance, Release, November 17, 2010). (Other States to follow?).

Nexus in Connecticut

The Connecticut Department of Revenue has determined that the business tax economic "nexus" standard will be met by any company, partnership, or S corporation that derives income from Connecticut or has a substantial economic presence within the state which in either case, is income "attributable to the purposeful direction of business activities toward Connecticut". (There is no nexus if business receipts from Connecticut source business activities are less than $500,000 - the "bright line" test).

Nexus in Virginia

The Virginia Department of Revenue has held that an out-of-state taxpayer who had no property, employees, or store inventory in Virginia did not have nexus in Virginia for income tax when it utilized a third party independent contractor service provider to perform repairs and maintenance on its behalf in Virginia. The taxpayer was considered to be purchasing services from a vendor and reselling them to its customers. (Ruling of Virginia Department of Taxation Commissioner, P.D. 10-252, November 10, 2010).

US Supreme Court Asked to Decide Nexus Case

An out-of-state corporation which was a passive investor in partnerships doing business in Kentucky has asked the US Supreme

Court whether Kentucky was correct in levying Kentucky income tax on the corporation's share of the partnership's income from Kentucky.

COMPUTING A CANADIAN CORPORATION'S INTEREST DEDUCTION FOR A US TAX RETURN

A Canadian corporation filing a US income tax return for business income cannot automatically deduct on its US income tax return the interest paid (or accrued) by the corporation's US activity (the US branch). Instead, the tax code has a <u>three step</u> procedure that must be followed to calculate the interest deduction on the US income tax return. The tax code rule stems, in part, from the desire to prevent a non-US corporation from incurring a disproportionate amount of debt in the US in order to reduce its US tax liability.

The three steps are as follows:

1) <u>Step One - Computation of US Assets</u>. (Reg. §1.882-5(b).

The corporation is required to compute the total value of its "<u>US assets</u>". An asset is treated as a "US asset" if all the income the asset produces, (or would produce if it produced income), and all of the gain, if any, that it would produce if sold, constitutes "<u>effectively connected income</u>". Therefore normally US business assets and US real estate, are "US assets".

The total value of the US assets for the year is the <u>average of the sums of the values</u> of US assets computed no less frequently than semi-annually (beginning, middle, and end of the taxable year), for most corporations, and more frequently for certain banks.

2) <u>Step Two - Computation of US-Connected Liabilities</u>. (Reg. §1.882-5(c).

The corporation next computes its a "<u>US-connected liabilities</u>". This is done by <u>multiplying</u> the total value of the foreign corporation's "<u>US assets</u>" (as determined in Step One) by an "<u>actual ratio</u>" or a "fixed ratio".

The actual ratio is the corporation's debt-to-asset ratio for the year - i.e. the total of its average worldwide liabilities for the year divided by the total value of its average worldwide assets for the year. The ratio must be determined annually (semiannually by certain banks). (Reg. §1.882-5(c)(2)).

The "fixed ratio" is 50% for <u>non-banks</u> and an election is required if you wish to use it. (Reg. §1.882-5(c)(4)).

3) <u>Step Three - Computation of the US Interest Expense</u>

The computation of the US interest expense is made under either the "Adjusted US Booked Liabilities" method, or the "Separate Currency Pools" method. This article summarizes only the "<u>Adjusted US Booked Liabilities</u>" method.

When the "<u>actual ratio</u>" method and the "<u>adjusted US booked liabilities</u>" method is used it is necessary to first <u>compare</u> the amount of "<u>US-connected liabilities</u>" as determined in Step 2, with the <u>average amount</u> of "<u>US booked liabilities</u>".

"<u>US booked liabilities</u>" are generally liabilities of the US business that are recorded on the US books at the time they are incurred. In a Private Letter Ruling the IRS ruled that liabilities <u>acquired by the branch's home office</u>, but recorded on the US books can qualify as "<u>US booked liabilities</u>" provided they are recorded contemporaneously on the US books. (PLR 200027018).

US Booked Liabilities Equal or Exceed US-Connected Liabilities

If the average amount of <u>US booked liabilities</u> equal or exceed the <u>US-connected liabilities</u> the corporation's interest deduction is the total interest paid or accrued by the US business during the year on <u>US booked liabilities</u> multiplied by the "scaling ratio". The "<u>scaling ratio</u>" is the amount of US-connected liabilities divided by the US booked liabilities. Thus the interest deduction is reduced proportionately.

US Booked Liabilities Are Less Than the US-Connected Liabilities

If the US booked liabilities are less than the US-connected liabilities the corporation's interest deduction is the amount of <u>interest paid</u> or accrued on the <u>US booked</u> liabilities <u>***plus***</u> the "<u>excess interest</u>". The "excess interest" is the excess of the <u>US connected liabilities</u> over the <u>average total amount of US booked liabilities</u> multiplied by a "special interest rate".

Simplistically, the "special interest rate" is the total <u>interest expense</u> paid or accrued on <u>US dollar denominated</u> liabilities on the corporations <u>***foreign** books*</u> divided by the average US dollar denominated liabilities on the corporations ***foreign*** books.

Thus, under a strict reading of the regulations, if the non-US corporation does not have US dollar denominated liabilities on its ***foreign*** books, the special interest rate cannot be determined and therefore the "excess interest" is not calculable.

However in Advice Memorandum (AM) 2009-015 the IRS announced that one reasonable approach to compute the special interest rate would be to use the actual average interest rate on the foreign corporations interest-bearing US dollar denominated liabilities that are "US booked liabilities".

Therefore, in the case where US booked liabilities are less than the US-connected liabilities the corporation's interest deduction on the US tax return can theoretically be greater than the actual amount of interest paid by the US branch! But if there is "excess interest", the "Branch Level Interest Tax" may become applicable. Please see the article "***BRANCH LEVEL INTEREST TAX***".

There are also limitations on the amount a US subsidiary can deduct for interest paid to its Canada parent. Please see the article "***INTEREST PAYMENTS FROM US CORPORATIONS TO CANADIAN AFFILIATES***".

GULF OF MEXICO OIL SPILL HIGHLIGHTS NEW US TAX PROBLEM FOR SOME CANADIAN BUSINESSES

Subscribers are aware the 5th Protocol to the Canada/US tax treaty made changes whereby a Canadian business will automatically be deemed to have a "permanent establishment" in the United States if it has employees present in the US beyond a prescribed time period under prescribed circumstances. (See the Summer, 2010, issue of the Taxletter). Thus, if the Canadian business meets the relevant criteria it will have a US federal (and perhaps State) tax filing requirement and perhaps a tax liability.

Absent tax code relief, the employee will also have a US tax filing requirement. Absent treaty relief the employee may have a US tax liability as well as a tax filing requirement. In this case, in addition to the employee having a US tax liability, the Canadian business has an obligation to withhold and regularly remit payroll tax withholding to the IRS on behalf of the employee.

However, how does withheld payroll tax get credited to the employee in the IRS records?

In the domestic context (i.e. when the employees are US citizens or US residents) the procedure is simple. At the beginning of each year the employer issues Form W-2 to the employee and the IRS. Among other items, Form W-2 shows the individual's name, address, US Social Security number, the amount earned in the prior year and the amount of payroll tax withheld on the individual's behalf.

What is the status of a nonresident alien working in the US for, say, 4 or 5 five months for a Canadian employer. The Canadian employer must normally issue Form W-2 to the employee and the IRS, but suppose the employee does not have a US taxpayer identification number? How does the tax withheld get credited to the Canadian employee if the nonresident alien employee does not already have a US taxpayer identification number?

Readers are generally aware of the procedure for a Canadian who is a nonresident alien of the US to obtain a US "Individual Taxpayer Identification Number" (ITIN).

However the tax code states that an individual with a US tax filing obligation must obtain a US Social Security number (as distinguished from an ITIN) if the individual has the right to work in the US.

In many cases individuals being sent to the US for an extended period of time will in fact have the right to work in the US. In many cases the right to work in the US will be given under a B-1 temporary work visa. Thus a Canadian worker temporarily in the US is generally required to obtain a US Social Security number, not an ITIN.

However to obtain a US Social Security number the individual must provide proof of his/here right to work in the United States. For Canadians, unlike other countries, there is usually no formal document issued for the B-1 visa.

Thus it might be difficult for such an individual to obtain a US security number because of the inability to provide the required documentation (paper copy of the B1 visa). As indicated above, the IRS rules provide that an individual is not eligible for an ITIN if he/she is qualified for a Social Security number. Thus there could be a quasi Catch-22.

However it appears if the individual applies to the US Social Security Administration for a Social Security number and receives a rejection letter, the rejection letter from the Social Security Administration will constitute a basis for the IRS to issue an ITIN. Of course all that can be time consuming.

The IRS is aware of this issue and at "press time" had not yet issued formal guidance on a solution. For the moment, absent following the lengthy procedure described immediately above, it may be possible for the Canadian employer to provide the IRS with an allocation of the tax withheld among employees, when it submits the relevant forms W-2 to the IRS.

Both the "permanent establishment" issue (associated with sending temporary workers into the US) and the taxpayer identification number issue associated with such temporary workers have been given a higher profile due to the large number of foreign workers that were brought into the US to assist in the aftermath of the Gulf oil spill.

CANADIAN "SNOWBIRDS" BRINGING CAREGIVER ASSISTANTS WITH THEM TO THE US

Some Canadian snowbirds bring "caregiver assistants" with them to the US during the winter, either to assist them personally, or as "nannies" for children. If these employees are paid for their US work (regardless of whether the payment is made back in Canada or in the US itself, and before or after the trip to the US) what is the US tax position:

1) Of the Canadian "snowbird" payer, and
2) The caregiver?

Readers are aware "US source income" is generally taxed in the US. Further, compensation for services performed in the US is treated as "US source income" regardless of when and where the payment is made. In addition, when wages are paid to an employee for services rendered in the US, the employer generally has an obligation to withhold income tax at source (and perhaps US Social Security tax in some cases).

US Income Tax Withholding Required by the Payer

A nonresident alien payer is, in general, required to withhold income tax on the US source wages regardless of where the payer is located. (IRC §3401).

However the regulations under IRC §3401(a)(c) provide an exception from wage withholding on income tax if the wages are exempt under an income tax treaty. Article XV of the Canada/US treaty provides, among other circumstances a potential exemption if the US source income does not exceed US $10,000.

Assuming the pro rata US source portion of the wages does not a exceed US $10,000 the employer should protect himself/herself against liability for failure to withhold, by complying with US requirements. In this case the employee should provide the employer with IRS Form 8233 which requires a US tax identification number. If the number has not been obtained but has been applied for, it is sufficient to insert "applied for" in the box for the required number.

The employee in turn, should file an annual US tax return reporting the income claiming an exemption from US tax under the provision of the tax treaty (again assuming the US source income portion of the payment does not exceed US $10,000. Form 8833 should be attached to the return explaining the basis for the exemption.

Alternatively, if the remuneration does not exceed $3,000 and the caretaker is not in the US more than 90 days, there may be an exemption from tax under Section 861(a)(3) of the tax code.

US Social Security Tax Withholding Required by the Payer

The IRS has ruled that US Social Security tax technically must be withheld in the circumstances described above, even for executives who visit the US on short business trips, absent an override by the Social Security Totalization Agreement. However apparently, in practice, when wages are exempt from federal income tax the IRS does not generally pursue the issue of Social Security tax.

US Immigration Status of the Employee

Of course an individual must obtain a US visa to legally work in the United States. Please consult your immigration attorney before taking any action.

US ESTATE TAX ON LIFE INSURANCE AND ANNUITIES

As in other aspects of US estate tax, the treatment of life insurance proceeds depends, among other factors, upon whether the decedent is:

1) A US citizen or US domiciliary (the latter being an individual who is considered to be "domiciled" in the US, or

2) A non-citizen that is not domiciled in the US - often referred to as a nonresident non-citizen ("NRNC").

Life Insurance Rules for US Citizens and US Domiciliaries

As a general rule, life insurance proceeds are subject to US estate tax (regardless of whether the polices are US or Canadian policies or other non-US policies) if:

a) The individual owned the policy (had "incidents of ownership") over the policy, (IRC §2042(1), or

b) The individual transferred the "incidents of ownership" within 3 years of death, (IRC §2035), or

c) The proceeds are payable to the individual's executor, (IRC §2042(1), or

d) The individual transferred "incidents of ownership" of the policy, other than for full and adequate consideration, and retained a lifetime right to beneficial enjoyment, a reversionary interest, or a right to alter, amend, revoke, or terminate the policy, (IRC §2033 and 2036), or

e) On the individual's death the individual owned a policy on someone else's life! (IRC §2033).

Life Insurance Rules for Nonresident Non-Citizens (NRNCs)

Readers recall NRNCs are generally subject to US estate tax on "US situs property". Life insurance proceeds from a US life insurance company insurer would appear be US situs property. However Code Section 2105 specifically provides that amounts receivable as insurance on the life of a NRNC are not to be considered US situs property.

Thus the estate of a NRNC who owns a US life insurance policy on himself/herself is not subject to US estate tax on the life insurance proceeds. (Obviously Canadian or other non-US life insurance would also be exempt, although the proceeds may have to be taken into consideration in the worldwide estate if the decedent's estate is claiming estate tax benefits under the Canada/US tax treaty).

However the exemption from US estate tax on US life insurance proceeds, only applies to insurance policies on the life of the decedent. If the NRNC decedent owned a US life insurance policy on another individual the policy would be subject to US estate tax. (IRC §2033).

Annuity Rules for US Citizens and US Domiciliaries

The gross estate includes the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent if under the contract, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive the annuity or payment either alone or in conjunction with another, for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. The amount includable in the estate is limited to that part of the annuity payment proportionate to the amount of the annuity's purchase price contributed by the decedent. (See IRC §2039 for additional rules).

Annuity Rules for Nonresident Non-Citizens (NRNCs)

Unlike life insurance where Code Section 2105 specifically provides that amounts receivable as insurance on the life of a NRNC are not to be considered US situs property, there is no code provision specifically providing the same treatment for annuities issued by US life insurance companies. Therefore apparently most commentators believe that the rules applicable to US citizens and resident aliens as described in Code Section 2039 (see above) apply to determine whether an annuity payment from a US annuity is subject to US estate tax for an NRNC. In other words, an NRNC would normally be subject to US estate tax on a US annuity. Reg. §20.2104-1(a)(4) may add credibility to this argument.

An alternative to this conclusion is that section 2105 (mentioned above) does not specifically use the word "life insurance company" but rather uses the words "amount receivable as insurance on the life of a nonresident" and therefore there is an argument that an annuity could be deemed to be property not situated within the United States. Presumably in this argument it would be necessary to establish that the annuity contract contained an "insurance risk" so that it could be treated as an amount receivable as "insurance on the life" of the nonresident alien.

In a unique set of circumstances the IRS determined that particular US annuities owned by a nonresident alien were not subject to US estate tax. (Private Letter Ruling 200842013 - please see the Winter/Spring, 2009, Taxletter) In this unusual case, the beneficiary of her brother's annuity failed to submit a claim to the insurance company before her own death. Therefore the proceeds of the annuities were still being held by the insurers at the time of the claim by the ultimate beneficiary. Thus the IRS held that the annuities were equivalent to deposits being "held by an insurance company under an agreement to pay interest" and therefore were considered exempt under Section 2105 (b)(1) and 871(i)(3)(C)).

MORE POTENTIAL PROBLEMS WITH CANADIAN TRUSTS FOR US ESTATE TAX AVOIDANCE

We previously described some of the US tax issues that are potentially troublesome when a US residence is purchased through a Canadian irrevocable trust to avoid US estate tax. Please see the Summer, 2010, and Winter/Spring, 2010, Taxletters, among others.

One potential concern occurs when a series of transactions occurs too quickly. For example, if Dad contracts to purchase a US residence, then Dad quickly forms a trust to purchase the residence, and the trust quickly purchases the residence, the IRS might treat the series of transactions as a taxable gift of the US residence from Dad to the trust. The IRS might assert this result under the US "step transaction doctrine", or alternatively the IRS could consider the quick series of transactions as tantamount to a gift of the residence to the trust. In either case, the gift tax, penalties and interest (compounded daily) potentially asserted against Dad could be significant ***if*** the IRS discovered, reviewed, and attacked the series of transactions.

IRC §2036 (Retained Life Estate)

Another serious concern is the effect Section 2036 of the Internal Revenue Code may have on such transactions.

Section 2036(a) states -

"*the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or monies worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death -*

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall process or enjoy the property or the income therefrom. (Emphasis supplied).

Thus, essentially, §2036(a) potentially says if a person transfers property without full payment and retains the right to use the property, the person might be subject to US estate tax on the property if the person continues to use the property after the transfer. The interpretation of this section of the Internal Revenue Code has been subject to numerous court cases, and at least one IRS Revenue Ruling and one Private Letter Ruling.

The results are reasonably clear when a trust is not involved.

Example 1: Dad gives his residence to his son with the understanding that dad will continue to live there until his death without paying rent. Result: Dad's estate is taxable on the residence even though he doesn't own it at death. (See Revenue Ruling 70-155). The right to continue to use the residence does not have to be in writing - it can be implied from the circumstances. However if the residence is transferred to a spouse, and there is co-occupancy of the residence by the husband and wife, the same estate tax result would not necessarily occur (at least as long as the donee spouse remains alive). (Rev-Rul 70-155).

Example 2: In the Estate of Daniel McNichol (29 TC 1179 (1959)) the decedent had transferred real estate to his children but continued thereafter to receive and treat all rents from the property as his own. Result: The property was taxable in the father's estate.

Example 3: In the Estate of Allen D. Gutchess vs. the Commissioner of Internal

Revenue (46 TC 554 (1966)) the husband gave the family residence to his wife and continued to occupy the residence with his wife. However there was no specific "agreement" between husband and wife giving the husband the right to live at the residence.

In this case the court decided that the spouses' joint occupancy of the home after the interspousal transfer of the residence was insufficient in and of itself to indicate the existence of an agreement for retained enjoyment by the husband. Therefore in this case, the residence was held not to be taxable in the husband's estate. However there was a strong dissenting opinion in the case and therefore the issue may not be totally resolved. Further, there could be a major change in the result if the wife died (or the couple divorced) and the husband continued to occupy the residence.

However when a trust is involved, the result might be different - especially when the trustee has discretion with respect to distributions to the beneficiaries (which is the case for many Canadian trusts).

Example 4: Mrs. A transfers property to an irrevocable trust in which the trustees have "sole and absolute discretion" as to making payments of the income from the trust. During Mrs. A's lifetime the trustee sent all the income from the trust to her, and this was deemed sufficient to warrant the conclusion by the court that there was a prearrangement between Mrs. A and the trustee that she was to have the income from the trust. Therefore it was held that the assets in the trust were includable in her estate. (Skinner's Estate v. United States 316 F.2nd 517, (1963)).

The judge suggested the decision places a **heavy burden** on the settlor of a discretionary trust to avoid the inference of **secret prearrangements** with the trustee when the settlor receives all the income. Note that in the case of Estate of Allen D. Gutchess v. Commissioner of Internal Revenue Service (above) the court emphasized that Congress made it clear that "**possession or enjoyment**" of the property is as important as "**the right to receive income**". (Thus, **is** there a potential danger of the property being subject to US estate tax if a Canadian husband arranges for a US residence to be acquired by a Canadian discretionary trust with a trustee that is "friendly" to the husband?).

Example 5: In the case Commissioner v. Estate of Church (335 US 632 (1949)) property was transferred to an irrevocable trust but the trust instrument required that the trustees pay income to him for life. In the course of the court's opinion holding that the property was includable in the decedent's estate, the court stated "*an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possessions and all of his enjoyment of the transferred property*". (Emphasis supplied).

IRC §2038 (Revocable Transaction)

Internal Revenue Code Section 2038 states that property will remain subject to estate tax if it is transferred "except in case of a bona fide sale for an adequate and full consideration……" by trust …… where the enjoyment thereof was subject at the date of the decedent's death to any change through the exercise of the power …………… by the decedent alone or by this decedent in conjunction with any other person………. to revoke or terminate"….. the trust. (Emphasis added and portions omitted).

Thus, very simplistically, if the settlor of the trust had the power (including implied power?) to cause the trustee to sell the residence in the trust and give the proceeds of the property back to the settlor, then the settlor (the decedent) might be subject to estate tax on the residence.

Is it a revocable transaction if, from the beginning, there is an understanding between the settlor and the trustee that if the residence is sold before the death of the settlor the proceeds will be returned to the settlor (directly or indirectly) by one of the beneficiaries?

IRC 643(i)

As we explained in the Summer, 2010 Taxletter, a new law, effective in 2010, provides that if a foreign trust permits the use of trust property by:

1) A settlor or beneficiary of the trust who is a United States person, or

2) Any United States person not described in 1) above who is related to such settlor or beneficiary,

then the fair market value of the use of the property will be treated as a distribution by the trust to such settlor or beneficiary for US income tax purposes. (IRC §643(i)).

We previously mentioned that, apart from the obvious individuals who are US persons, (e.g. US citizens, US residents and green card holders) snowbirds who meet the substantial presence test but fail to timely file a valid IRS Form 8840 for the tax year are also US persons and therefore subject to this rule.

Distributions from trusts are not normally subject to tax unless the trust has current or accumulated earnings. Will the IRS ever attempt to treat the trust as having received earnings as a result of "deemed rental income" from individuals using the residence?

Moreover, if the trust sells the US residence for a profit, and reinvests the profits in another US residence, without distributing the profits to beneficiaries, the trust would have accumulated profits, thus potentially triggering tax for any relevant "US persons". In this case, if there is personal use of the new residence the deemed distribution rule could, have US tax consequences, even for Canadian snowbirds who are "US persons" because they meet the US "substantial presence test" but fail to timely file IRS Form 8840.

Also, if there is "mixed use" of the property, i.e. it is used personally and rented out, there could be earnings in the trust, in which case Section 643(i) could apply to levy US tax on certain snowbirds, as well as other US persons.

Accumulation Distributions

For another problematic issue associated with the ownership of a US residence through a Canadian irrevocable trust, the settlor and/or beneficiary must be alert to the US rules for "accumulation distributions" from foreign trusts, to be summarized in the next Taxletter.

HOW TO STRUCTURE US INVESTMENTS (VIA PARTNERSHIPS)

Much has been written about how to structure the purchase of a US residence to avoid US estate tax. Among other vehicles, the use of a Canadian trust or a Canadian partnership with a potentially ultimate US "check-the-box" election have often been mentioned.

However how should Canadian unrelated parties who intend to purchase or commence a US business or US rental real estate rental real estate activity structure their venture? Similarly, if a Canadian is joining with a US resident how should the investment be structured?

Of course it is common for Canadian corporations to form a US subsidiary to conduct their US business. However often this may result in a larger amount of aggregate US and Canadian income tax than necessary, by the time the US profits are ultimately received as "after tax" dollars in the hands of the Canadian individuals who are shareholders of the Canadian parent corporation.

When US estate tax is not an overriding concern, a practical alternative to reduce the aggregate worldwide tax in some investments may be the use of a partnership. However there are many different types of US partnerships and each has advantages or disadvantages compared with the other types.

A US ("domestic") partnership is a partnership formed in the United States. A foreign (non-US) partnership is a partnership formed in the country other than the United States.

All domestic partnerships other than general partnerships must be formed under State law. US individual State laws provide for many different types of partnerships. Some types of partnerships are provided for under some State laws but not under other State laws. Also, the legal rules for a given type of partnership may vary from State to State. Further, limited liability that is provided under a particular State's law may not provide limited liability in another State. Therefore please contact your legal and tax advisor before taking any action.

General Partnership

A general partnership is a relationship between two or more individuals or entities that intend to carry on a business together. The mere association of the two with the intent to carry on business for profit as co-owners constitutes a partnership, whether or not a partnership is in fact intended. It is not necessary to have a written partnership agreement to be considered a general partnership. A distinction can be made with the co-ownership of rental real estate, where the intent is not to carry on business - the only intent is to share the income and expenses of the rental property. In a general partnership all partners have unlimited liability for acts of the partnership and all partners have the right to take part in the management of the partnership.

Limited Partnership (LP)

A limited partnership, unlike a "general partnership", has one or more general partners who have the right to make decisions and the right to take part in the management of the partnership and one or more limited partners who generally do not have the right to take part in the management of the partnership. The latter are usually inactive partners. As in a general partnership, the general partner has unlimited liability for acts of the partnership whereas in the LP the limited partners do not have liability for acts of the partnership. Consequently in this type of partnership, a corporation or other limited liability entity is often used as the general partner.

Limited Liability Partnership (LLP)

An LLP also has one or more general partners and one or more limited partners. The partnership agreement describes the rights of the general and limited partners to make decisions and to take part in the management of the partnership.

In an LLP the partnership agreement often provides that the limited partners (as well as the general partners) can participate in the management of the partnership. Thus, in the operational context, an LLP can be more like a general partnership than a limited partnership. However in the LLP the general partner has limited liability - thus all partners have limited liability and it is not necessary to have a corporate general partner. The obligation for any act of an LLP is limited to the partnership. (Certain "Professional" LLPs may have different rules).

Limited Liability Limited Partnership (LLLP)

Similarly, an LLLP also has one or more general partners and one or more limited partners and the partnership agreement describes the rights of the general and limited partners to make decisions and to take part in the management of the partnership.

However in an LLLP, the general partner(s) would often have the exclusive right(s) to manage the partnership, with the limited partners being inactive. Hence some LLLPs may be viewed operationally more like an LP that an LLP or general partneship. However, in an LLLP the general partner has limited liability, thus eliminating the need for a corporate general partner. As a result, an LLLP may often be used in lieu of an LLP when it is anticipated that some of partners (the limited partners) would truly be inactive in the business, thus giving control of the partnership to the general partner(s).

Family Limited Partnerships (FLP)

A family limited partnership is, by definition, comprised of partners that are related. They have been formed in some cases to shift income from high tax bracket family members to lower tax bracket family members.

They have also been used in the estate tax context to attempt to claim discounted values on assets required to be included on Estate Tax Returns.

Caveat

Limited Liability Partnerships (LLPs) and especially Limited Liability Limited Partnerships (LLLPs) are relatively recent additions to State legal statutes and therefore have not received extensive use, analysis, or state or other legal guidance. Therefore please contact your legal and tax advisor before taking any action.

Tax Advantages of a Partnership

A main advantage of the partnership structure is that the partnership itself is generally not subject to income tax. A partnership is a "flow -through" entity in which the partners are subject to tax on the partnership's income rather than the partnership. The partnership must file an income tax return, and each partner must file an income tax return based on tax information provided to the partner from the partnership.

For example, if one or more Canadians investing in a US business own their partnership interest directly in their own individual names, each Canadian will file a US income tax return and a Canadian income tax return reporting his/her share of the partnership income.

However the Canadian partner will normally receive a "foreign tax credit" in Canada for all or part of the actual tax paid to the United States. Thus, in most cases the worldwide aggregate tax for a Canadian partner will be limited to the greater of the Canadian or US tax, and the cash earnings of the partnership can now be directly in the hands of the Canadian partner, rather than having to go through a circuitous route of corporations.

The partnership structure may be especially useful when a Canadian partner is joining with a US resident partner in a US business or US rental property. This occurs because the US partner will be accustomed to using a "flow through" entity to reduce his own US tax liability. The vehicle of choice these days for US residents is often the US "Limited Liability Company" ("LLC"). However, as previously mentioned, the LLC may not be appropriate for the Canadian partner because the Canada Revenue Agency may treat the LLC is a corporation, thus creating a lack of coordination between the Canadian partner's taxation in the United States and Canada.

Thus, a partnership can be an obvious compromise vehicle for investment because it provides "flow-through" taxation for both the Canadian and US partner.

The selection of an LLP or LLLP will often depend, in part, upon whether all partners will be active in the business or whether one or more partners will be inactive, and whether the general partner wants to "control" the business. Please see the comments on LLPs and LLLPs above and consult your legal and tax advisors before taking any action. Of course, the potential impact of US estate tax must always be considered.

Please also see the article ***"USING PARTNERSHIPS FOR US BUSINESS OR INVESTMENT"***.

YOUR "REQUIRED" TAX YEAR FOR YOUR US TAX RETURN

The US has tax rules that determine the time period that must be covered when you file a US income tax return. This is referred to as your "taxable year" or "tax year".

General Rule

Your taxable year is generally your annual accounting period if:

1) It is a calendar year, or

2) A fiscal year. IRC §441(a)).

However your tax year must be the calendar year if:

1) You keep no books, or

2) You do not have an accounting period, or

3) You have an annual accounting period that is not the calendar year but does not qualify as a fiscal year. (IRC §441(g)).

Thus, under the **General Rule** your tax year could either be the calendar year or a fiscal year - the latter being any year that ends in a month other than December. For U.S. purposes, tax years must generally end at the end of a month. (IRC §441(d) and (e)). A taxable year generally cannot cover more than 12 calendar months. (Reg. §1.441-1(a)(2)).

Of course if an entity is liquidated at a time other than the end of a month its taxable year would end then. Special rules apply to a taxpayer which computes its income on the basis of an annual period which varies from 52-53 weeks.

Required Tax Year

However many taxpayers, as described below, must use a particular tax year (a "Required Tax Year"), as described below, rather than a tax year determined under the **General Rule**, described above. Among others this includes, certain partnerships, trusts, "S" corporations, personal service corporations, specified foreign corporations, common trust funds, and real estate investment trusts.

A New Taxpayer

A taxable year of a new taxpayer is adopted by filing its first federal income tax return using that taxable year. The filing of an extension, or the application for an employer identification number, or the payment of estimated taxes for a particular year does not constitute an adoption of that taxable year. (Reg. §1.441-1(c)(1)).

A newly-formed partnership, "S" corporation, or personal service corporation (PSC) that wants to adopt a taxable year other than:

1) Its "required tax year", or

2) A taxable year elected under Section 444, or

3) A 52-53 week taxable year that ends with reference to its required taxable year elected under Section 444

<u>must establish a business purpose and obtain the approval of the IRS</u>. (Reg. §1.441-1(c)(2)(i). See Elections Under Section 444" below.

Individuals

Individuals are subject to the <u>**General Rule**</u>. For this reason most individual must use the calendar year.

A resident <u>alien</u> or nonresident <u>alien</u> who has not established a taxable year for any prior period must use the <u>calendar year</u> as his/her taxable year. But an alien may use a <u>fiscal</u> year if the individual has not previously filed a US income tax return on a calendar year basis, and the individual can also show that he/she <u>uses a fiscal year in his/her home country</u> and otherwise keeps his/her books on a fiscal year basis. (IRC §7701(b)(9)).

Partnerships

Unless a business purpose for using a different year can be proven to the IRS the taxable year of a partnership must be:

1) The "majority interest taxable year" which means the taxable year which, on each testing day, constituted the taxable year of one or more partners having an aggregate interest in partnership and profits and capital of more than 50%, or if this does not resolve it,

2) The tax year of all the principal partners of the partnership, (a principal partner is a partner having an interest of 5% or more), or if this does not resolve it,

3) The taxable year is the calendar year, (except see ***Elections Under Section 444" for Partnerships, "S" corporations, and PSCs below***. (IRC §706(b)).

These rules appear to apply to Canadian partnerships that are engaged in business in the United States through a "permanent establishment", and to Canadian partnerships involved in U.S. real estate rental activity.

"S" Corporations

A US corporation that is an "S" corporation must have a tax year that is the calendar year unless it can meet one of two exceptions - i.e. be able to demonstrate a business purpose for a fiscal year, or, in special cases, elect to have a fiscal year. (IRC §1378). See ***Elections Under Section 444 for Partnerships, "S" corporations, and PSCs below***.

Personal Service Corporations (PSCs)

A corporation that is a "personal service corporation" must also use a calendar year, unless it;

1) Establishes "to the satisfaction of the Secretary" a business purpose for a different year, or

2) Makes an election under Section 444, or

3) Elects to use a 52-53 week taxable year that ends with reference to a calendar year or a year elected under Section 444.(IRC §441(i) and Reg. §1.441-3(a)(2)).

Elections Under Section 444 for Partnerships, "S" corporations, and PSCs

Despite the rules described above for Partnerships, "S" corporations, and PSCs, these entities may potentially elect to have a "<u>permitted</u>" tax year rather than the "<u>required tax year</u>". (IRC §444).

In general the election can only be made if the "deferral" period of the taxable year elected is not longer than three months. For example, if a partnership's "required tax year" is December 31, and it elects a taxable year of November 30, it has a deferral period of one month.

See IRC §7519 relating to payments required by partnerships and "S" corporations making the election and Section 280H relating to deduction limitations for PSC's making the election.

“<u>Exception for some "Tiered Structures</u>"

In general, no Section 444 election may be made with respect to a partnership, "S" corporation, or PSC that is a member of a "<u>tiered structure</u>". (Reg. §1.444-2T(a)).

A partnership, "S" corporation, or PSC is considered a member of the tiered structure if:

1) The partnership, "S" corporation, or PSC directly owns any portion of a "deferral entity", or

2) The "deferral entity" directly owns any portion of the partnership, S corporation or PSC. (Reg. §1.444-2T(b)(1)).

A "deferral entity" means an entity that is a <u>partnership, S corporation, PSC, or trust</u> (other than a grantor trust). (Reg. §1.444-2T(b)(2)).

A Section 444 election can potentially be made <u>despite these exceptions</u> if the tiered structure consists only of partnerships, or "S" corporations (or both) <u>if they all have the same tax year</u>.

An anti-abuse rule exists under Reg. §1.444-2T(b)(3) and a de minimus rule exists under Reg. §1.444-2T(c)(1)).

Corporations

Most US corporations that are "C" corporations, most US Limited Liability Companies (LLCs) that are taxed as corporations, and most Canadian corporations engaged in U.S. business through a "permanent establishment" (and have no "U.S. shareholders"), are subject to the **General Rule** mentioned above and entitled potentially to have a calendar tax year or a fiscal tax year. But see the special rule below for certain "controlled foreign corporations ("CFC"s).

Special Rule for Certain CFCs - A Canadian or other non-U.S. corporation is subject to special rules for its "Required Tax Year" if it is a "controlled foreign corporation" (CFC) as defined in the tax code, in which a "US shareholder" owns more than 50% of the voting power or 50% of the equity of the corporation. In this case the "Required Tax Year" must generally be the "majority U.S. shareholder year" as set out in IRC §898. The stock attribution rules of Section 958 are applied for purposes of determining stock ownership.

Proposed IRS regulations (published in 1993, but not yet promulgated) provide conditions under which your Canadian or other non-U.S. corporation will not be required to have a tax year that is the "majority U.S. shareholder year" (The "Required Tax Year"). In part, this would apply if no U.S. shareholder has income required to be included on his/her personal U.S. income tax return under the CFC rules. (Prop. Reg. 1.898-1).

Otherwise, (under the proposed regulations) once a U.S. shareholder has income required to be included in income for US income tax purposes under the CFC rules, the corporation must comply with the "Required Tax Year" rule beginning with the first taxable year subsequent to the year in which the income is first included under the CFC rules. (Prop. Reg. 1.898-1(c)(1)).

The proposed regulations also provide rules describing how you change your year-end to comply with this special corporate rule, and how you address a situation where you would be required to include more than 12 months of income on the US shareholder's U.S. income tax return because of the requirement to change your corporate tax year. (Prop. Reg. 1.898-4).

Trusts

A trust that is actually taxable as such (as distinguished from a so-called "grantor trust") must use the calendar year as its tax year unless it is a tax-exempt trust or a charitable trust. (Code Section 644).

Estates

An estate is subject to the **General Rule** described above, and thus it may have a fiscal year for U.S. income tax purposes.

ANATOMY OF AN AUDIT

By Robert S. Blumenfeld, Esq.,
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"How is a mugger different from the Internal Revenue Service? They both take your money, but the mugger doesn't make you fill out the forms." Jacob Sullum.

Jose (not his real name) is a US citizen who lives in a South American country. He received a Notice from the Internal Revenue Service that he owed them approximately $400,000 for 2001 and 2002, and if he did not pay the liability within 30 days, they were going to put a lien on a very substantial piece of vacant property that he owns in Florida.

Looking into this situation, I found that the IRS was basing its tax liability on two certificates of deposit which Jose had with a local brokerage firm. The account had generated some interest income which was reported to the IRS on IRS income reporting Form 1099, (similar to a Canadian "T" slip) and Jose had failed to file IRS Forms 1040 (US income tax return) for the two years in question.

Once I received a copy of the 1099s from the brokerage firm the mystery deepened. The total income produced by the two accounts was slightly over $6,000. Given the standard deduction and the annual exclusion, there should have been no reason for $6,000 to generate any kind of IRS activity since it is below the minimum threshold for filing a return, and José had no other income (that he told me about).

The IRS, (as I know having worked there for 32 years), is reflexive. Unless they receive some kind of information inconsistent with the data in their computer system, they take no action, so obviously something more devious than the $6,000 in unreported income was at play. Think about it. Even if you had $6,000 in income and didn't report it, and had no exemptions or standard deduction, how could this amount produce $400,000 in tax?

I obtained transcripts of José's tax returns from the IRS. I noticed that they were basing a substantial part of the tax on short term capital gain transactions which really didn't make sense since José owned no capital assets. To confirm this, I called his account executive and obtained complete copies of all transactions within his account for the calendar years 2001 and 2002.

I also asked the account executive for copies of every document that the brokerage firm had sent to the Internal Revenue Service on behalf of José's brokerage activity. Now the mystery was answered. The brokerage house, for some arcane reason, had sent a second set of 1099s to the IRS reporting the rollover of the certificates of deposit as capital transactions.

This is totally incorrect, but the Internal Revenue Service computer simply sees that assets have been "sold", X dollars were received and no capital gains schedule was attached to the tax return (i.e. there was no way for the IRS to know the individual's "cost base" in the CDs). Now that I was aware of why Jose had received a bill for $400,000, how do we make it disappear?

Two situations had to be addressed here; the IRS had to be stopped from selling the liened property before the matter could be resolved, and the liability had to be removed. First, I called some people that I know at the IRS and had them insert a "freeze code" into the computer system. What this basically does is to tell any IRS agent who looks at the account that he/she is to take no activity with regard to this account until the freeze is removed.

The second situation was a little more problematic - you can't just call the IRS and say that your brokerage house sent an incorrect 1099 to the IRS. Even if you get the brokerage house to send in a corrected IRS Form 1099, it is a long, convoluted process before this actually reaches the tax return in the computer system. The quickest way to deal with this, especially since no returns had ever been filed for the years in question, was to prepare tax returns. On the returns I reported the interest income of $6,000, and then on the capital gains schedule (IRS Form Schedule D) I reported each item listed on the 1099, inserting a cost base of the CDs equal to the sales price so there was no gain reported on the tax returns. The tax return then became nontaxable.

There was still one thing left to do. When a lien is removed from a piece of property, the IRS has 30 days to record the removal. In many cases however, this does not happen so I had to be vigilant to make sure that it did happen. If it had not happened, I would have had to physically go to the IRS with the documents and have the release issued and sent to the proper courthouse for recordation.

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INTEREST PAYMENTS FROM US CORPORATIONS TO CANADIAN AFFILIATES

Some Canadian businesses conduct their US business through a US subsidiary that is funded by the Canadian parent corporation. The Canadian and US tax advisors often discuss how the funding is to be characterized - i.e. generally as a loan, or an investment in shares, or some combination of the two.

In both countries many considerations may enter into a determination of the structure to be used. In the US, rules regarding "imputed interest", (e.g. IRC 483 and 7872), "thin capitalization", (e.g. IRC §385 and case law), and "re-allocation of income and deductions between related parties" (IRC §482), must be considered, among others.

However the US tax code also contains additional "interest stripping" rules. These are rules that limit the interest deduction to the payer corporation when interest is paid "from any corporation" to a "related person". The law can have the effect, among others, of preventing a US corporation from shifting the profit of the US corporation to a Canadian related party. It may also affect the deduction of interest between two related US corporations. Any such interest deduction that is limited can be carried forward and perhaps deducted in a subsequent year. (IRC §163(j)).

The interest deduction limitation applies if:

1) The payment is to a "related person".

2) The interest is "disqualified interest" (IRC §163(j)(1)(A)),

3) At the close of the taxable year the debt to equity ratio of the payer corporation exceeds 1.5:1. (IRC §163(j)(2)(A)(ii), and

4) The corporation has "excess interest expense" for the year. (IRC 163(j)(2)(A)(i)).

Related Person

Among numerous other circumstances, the following are related persons (IRC §163(j)(4) and §267(b)):

1) Certain family members,

2) A corporation and a partnership if the same persons own --

a) more than 50% in value of the outstanding stock of the corporation, and

b) more than 50% of the capital interest, or the profits interest, in the partnership

3) Two corporations which are members of the same "controlled group". The definition of "controlled group" is quite extensive. There can be a parent-subsidiary controlled group, a brother-sister controlled group and a combined group. (See IRC §267(f) and IRC §1563).

Disqualified Interest

Among other situations, disqualified interest is any interest paid to a related person if "no US tax is imposed" on the interest. (IRC 163(j)(3)(A)). If a treaty reduces the rate of US tax on the interest paid or accrued by the payer, the interest will be treated as "interest on which no tax is imposed". (IRC §163(j)(5)(B)) and Proposed Regulation. §1.163(j)-4(a)). Of course the Canada/US tax treaty generally exempts Canadian corporations from US tax on US source interest, provided the interest is not "effectively connected" with a US trade or business of the Canadian corporation which has a "permanent establishment" in the US (Treaty Article XI(3)). (Note that 2010 is the first year for a complete exemption for non-arm's length interest).

Excess Interest Expense

The "excess interest expense" is the excess, if any, of the corporation's "net interest expense", over the sum of 50% of the "adjusted taxable income" of the corporation, plus any excess limitation carryforward. The "adjusted taxable income" of the corporation means the taxable income of the corporation computed with several adjustments including the net interest expense, any net operating loss deduction, and any deduction for depreciation, amortization or depletion. "Net interest expense" means the excess of interest paid or accrued over the amount of interest included in gross income. (IRC §163(j)(6)(B)).

See also Proposed Regulation 1.163(j)(4) issued in 1991 and the article in this Taxletter ***"US ESTATE TAX CONSEQUENCES ARISING FROM CORPORATE INTEREST DEDUCTION RULES "***.

CANADIANS USING PARTNERSHIPS FOR US BUSINESS OR INVESTMENT

When one is evaluating the taxation of a partnership it is necessary to determine, among other things, whether the partnership is a US (domestic) partnership or foreign partnership, whether the partnership is a resident or nonresident of the US, whether the partnership is engaged in a US trade or business, whether the partnership has US source income or foreign source income, and whether there are domestic partners or foreign partners.

Domestic vs. Foreign Partnership

A partnership is a domestic (US) partnership if it is created or organized in the United States or under laws of the United States or of any State. (IRC §7701(a)(4)). Otherwise it is a foreign (non-US) partnership.

Resident vs. Nonresident Partnership

A resident partnership is a partnership engaged in a trade or business in the US. A nonresident partnership is a partnership not engaged in a trade or business in the US. (Reg. §1.301.7701-5). The residence of a partnership is not affected by the nationality or residence of its members or by the country where it created or organized. (Reg. §1.301.7701-5). Thus it appears a domestic partnership could potentially be a nonresident.

The US trade or business of a resident partnership (regardless of whether it is a domestic or foreign partnership) is imputed to its foreign partners (as well as domestic partners) potentially subjecting the foreign partners to US tax on their share of the partnership's US source income that is effectively connected with the US trade or business - and in some cases also on foreign source income. (See "Foreign Source Income" below).

Taxation of Foreign Partners

The US jurisdiction to tax a *foreign* partner of a domestic ***or*** foreign partnership is initially based on whether the partnership is engaged in a US trade or business. (See ***Treaty Override*** below)

A foreign partner in any partnership (domestic or foreign) may be subject to US tax if the partnership is engaged in a US trade or business (subject to treaty provisions - See "***Treaty Override***" below). The foreign partner is taxed on his/her share of the US source business income that is "effectively connected" with the US trade or business. (Of course, the foreign partner may also be subject to tax separately on "fixed or determinable" income such US interest, US dividends or other US fixed income such as US royalties, regardless of whether they are earned by a domestic or foreign partnership).

A foreign partner in any partnership (domestic or foreign) will also be considered engaged in a US trade or business if the partnership itself is considered engaged in a US trade or business. (IRC §875(1)). This applies to both general partners and limited partners. (Revenue Ruling 75-23). It is also possible, that in some limited cases, a partner's activity on behalf of the partnership could be attributed to the partnership. Further, when a limited partnership conducts business in the US through fixed place of business (such as an office) the office of the limited partnership is a "permanent establishment" in the US with regard to each limited partner. (Revenue Ruling 85-60)

US Source Income. If the partnership (and thus the foreign partner) are engaged in US business then all US source income (other than the fixed income described above and certain capital gains) are considered "effectively connected" with the US trade or business and taxable to the foreign partner. Thus, for example, US source sales of goods from a separate activity that does not constitute a US trade or business can be subject to US tax. (IRC §864(c)(3)).

Foreign Source Income. Normally a foreign partner in a domestic (or foreign) partnership is not subject to US tax on the partnerships foreign (non-US source) income. (Reg. §1.702-1(a)98)(ii)).

However in limited cases, foreign source income will be considered "effectively connected" with the US trade or business and thus taxable to the foreign partner if there is an office or fixed place of business in the US to which the income is attributable. (IRC §864(c)(4)(B)).

Thus the source rules of the tax code (among other factors) are relevant in determining the amount of any (domestic or foreign) partnership's trade or business income that is subject to US tax by a foreign partner.

Readers recall that income from services is generally sourced where the work is performed and income from the sale of goods is generally sourced where the rights, title, and interest of the seller are transferred to the buyer. The point at which "risk of loss" changes can be a factor - See Reg. 1.861-7(c).

Determining The Partnership's "Effectively Connected" Taxable Income

If the partnership has both domestic source and foreign income and expenses the computation of US effectively connected income can become complex.

In general the regulations provide that the allocation and apportionment of expenses are determined in a two-step process.

1) First, expenses are allocated to classes of gross income, and then

2) Expenses allocated to a class of gross income are apportioned among statutory and residual groupings of gross income.

1) Allocation - The gross income to which a deduction is definitely related is a referred to as a "class of gross income", as selected from "Gross Income" as defined in Code Section 61 - for example: compensation for services, gross income derived from business, gains derived from dealing in property, distributive share of partnership gross income, etc.

2) Apportionment - Allocation as described above is the identification of a deduction with a specific class of gross income. (Reg. §1.861-8(b)(1)). It is based on the factual relationships between the expense and the class of gross income.

The second step (apportionment) involves the division of a deduction, after it has been allocated to a class of gross income, between the statutory and residual groupings of gross income within that class. (Reg. §1.861-8T(c)).

The statutory grouping of gross income (Reg. §1.861-8(a)(4)) is the gross income that is in the class of gross income described above and that relates to the operative section with which one is concerned. (Reg. §1.861-8(f)((1)).

The residual grouping includes all gross income other than gross income in the statutory grouping. For example, if foreign source income is the relevant statutory grouping, US source income is the residual grouping. (Reg. 1.861-8(a)(4)).

Special rules apply to interest expense.

The rules can be a extensive in their level of detail - please see a list of all the regulations under Section 861.

Treaty Override

Subscribers are aware Canadian partners are subject to US income tax on their share of income "effectively connected with a US trade or business, unless they do not have a "permanent establishment" in the US. The IRS takes the position that the rule of IRC §875(1) also applies for determining a partner's status with respect to having a US "permanent establishment". (Revenue Ruling 90-80). In other words, if the partnership has a US permanent establishment each partner will be deemed to have a US permanent establishment.

Summary

Nonresident aliens resident in Canada that are partners in any partnership (e.g. Canadian or US partnership) that has a "permanent establishment" in the US. are subject to US income tax on the partnership's US source business income if the partnership is engaged in business in the US and has US source income effectively connected with that business. In certain limited cases, the Canadian partner is also subject to US tax on the partnership's foreign source income that is effectively connected with the US business and is attributable to a US office or fixed place of business of the partnership.

If the partnership is engaged in US business with a US permanent establishment and has both US source and foreign source income, complexities can arise in determining the nonresident alien's portion of the taxable income from the partnership.

US Tax Return Filing Requirements for Partnerships

When is a domestic or foreign partnership required to file a US federal income tax return? (Note that individual State requirements may be more stringent).

Domestic Partnerships. Every domestic partnership must file a US federal income tax return unless it neither receives income nor incurs any expenditures treated as deductions or credits for federal income tax purposes. (Instructions to IRS Form 1065).

Foreign Partnerships. Subject to "Exceptions" below, a foreign partnership must file a US income tax return if it has:

a) Gross income effectively connected with a US trade or business, or

b) Other gross income from US sources (for example interest, dividends, and royalties).

A foreign partnership required to file a US federal return generally must report all its foreign and US source income. (Instructions to IRS Form 1065).

Exceptions. There are limited cases in which a foreign partnership that did not have income effectively connected with a US trade or business is not required to file a US federal income tax return. Please refer to the Instructions to IRS Form 1065.

Please also see the article "***HOW TO STRUCTURE US INVESTMENTS (VIA PARTNERSHIPS)***".

US ESTATE TAX CONSEQUENCES ARISING FROM CORPORATE INTEREST DEDUCTION RULES

Some genuine business interest expense that would be deductible, even after taking into consideration the issues in the article "***INTEREST PAYMENTS FROM US CORPORATIONS TO CANADIAN AFFILIATES***", may still not be deductible to the business.

In general there is no deduction for an interest payment on any "registration-required" debt" unless the debt is in 'registered' Form. (IRC §163(f)). (See "***Estate Tax Importance of §163(f)***") below.

"Registration-required" debt is any debt other than debt which:

1) Is issued by a natural person,

2) Is not of a type issued to the public, or

3) Has as a maturity (at issue date) of not more than one year. See also Reg. §5f.163-1.

This rule obviously has little or no significance for interest deduction purposes for most private businesses, including individuals with rental property and sole proprietorships.

However it can have major significance for nonresident aliens with respect to the US estate tax status of debt issued by US public corporations. - i.e. a nonresident alien who invest in US public corporate debt.

Readers are aware nonresident aliens are generally subject to US estate tax on US property. Debt issued by a US resident or entity is generally US property. However such US debt will not be US property, and thus not subject to US estate tax, if the debt meets the provisions of IRS Section 871(h)(1) - i.e. if the debt is a "portfolio debt investment". (IRC 2105(b(3)).

Estate Tax Importance of §163(f)

Although the rules defining "portfolio debt investment" and corresponding "portfolio interest" can be complex - simplistically a nonresident alien will not be subject to estate tax on US debt if the debt is in "registered form". This is where Section 163(f) ("registration-required debt") described above becomes important.

Obviously most public US corporations want to obtain a deduction for their interest expense. To do so the debt must be "registered" as required under Section 163(f)). It is this connection between the estate tax rules and the rules for the deduction of interest that enables nonresident aliens to purchase most US publicly issued corporate debt without being exposed to US estate tax - i.e. a corporation will obviously want to have its debt in the "registered" form to obtain the interest deduction. However when buying such debt, the Canadian investor should obviously review the Prospectus for the section containing the estate tax status legal opinion for nonresident aliens regarding the corporation's debt.

When debt is not issued by such corporations, - i.e. it is issued by a natural person or a type not issued to the public, it is potentially subject to US estate tax. However by adding certain language to the debt it is possible to convert the debt to "registered debt", thereby exempting it from US estate tax for a nonresident alien.

In either case, please consult your tax advisor before taking any action.

US TAX FEDERAL TAX INSTALLMENT PAYMENTS REQUIRED BY CORPORATIONS

Income tax installment payments (referred to as "estimated" tax payments in the US) must generally be made during the course of the year if a corporation will have a US income tax liability for that year. In addition to US federal estimated tax payments, individual State estimated tax payments may also be required if the corporation has income (or was formed) in a State that has an applicable corporate income tax. Penalties apply for noncompliance.

US Federal Requirements

Domestic (US) and foreign (non-US) corporations generally must make four equal installments of federal "estimated" tax if the year's tax liability is expected to exceed $500. The payments are made with preprinted IRS Form 8109-B and are due on the 15th day of the 4th, 6th, 9th, and 12th month of the corporation's tax year. In come cases the tax must be remitted electronically.

Preprinted Forms 8109-B are issued in booklet form by the IRS as a result of applying for a US tax ID number (or if a corporate tax return is filed without a number). You can obtain a substitute Form 8109-B by calling the IRS at 1-800-829-4933 provided you have a tax ID number. Please see Exhibit 1.

BRANCH LEVEL INTEREST TAX

Depending on calculations described in the article "***COMPUTING A CANADIAN CORPORATION'S INTEREST DEDUCTION FOR A US TAX RETURN***" a non-US corporation may deduct more interest on its US income tax return than it actually paid - i.e. it may deduct the "excess interest" described in that article.

In the case of foreign corporation that is engaged in business in the US *any* interest paid by the US business (the "branch interest") is treated as if it were paid by a domestic corporation. If the interest is paid to a non-US source the normal US withholding rules apply. (Reg. §1.884-4(a)(1)).

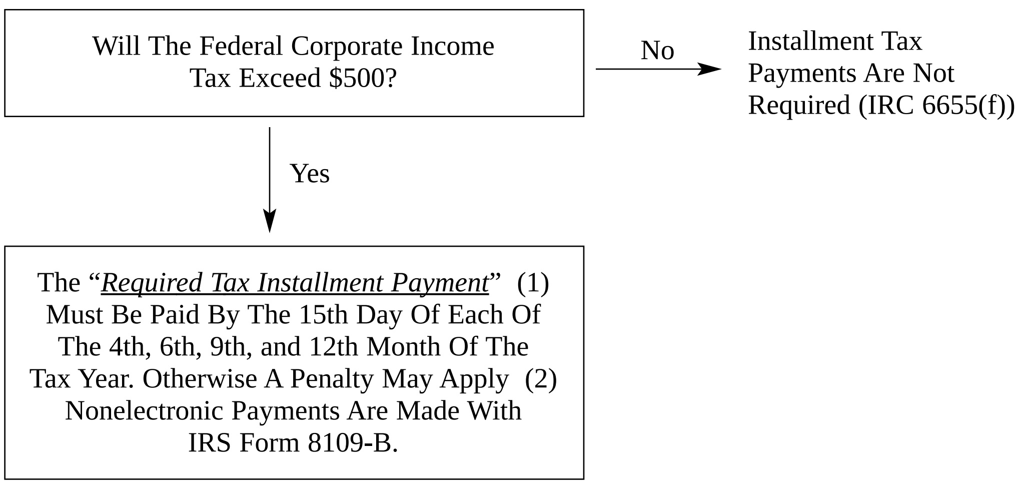
If the foreign corporation has "excess interest" described in the article "***COMPUTING A CANADIAN CORPORATION'S INTEREST DEDUCTION FOR A US TAX RETURN***", the excess interest is treated as if it were interest paid to the foreign corporation by a wholly-owned domestic subsidiary. (Reg. §1.884-4(a)((2)(ii)). Thus, in the "normal" case, a 30% US withholding tax would apply to this excess interest (referred to as the "Branch Level Interest Tax").

For tax year 2010 and thereafter the non-arm's length tax treaty rate on interest paid from a US corporation to a Canadian resident parent is 0% and therefore there is apparently no branch level interest tax on the excess interest, provided the corporation meets the "limitation on benefits" provision of the tax treaty and other requirements. (Reg. §1.884-4(b)(8)).

In cases where the rules described above actually result in branch level interest tax, a corporation has the option of electing under Reg. §1.884-1(e)(3) to reduce it's "US -connected liabilities", to avoid the branch level interest tax. Please see also the article "***INTEREST PAYMENTS FROM US CORPORATIONS TO CANADIAN AFFILIATES***".

EXHIBIT 1

US Federal Rules For Corporate Estimated (Installment) Tax Payments



(1) *Required Tax Installment Payment.*
The "Required Installment Payment" (IRC 6655(d)) Is 25% Of The Lessor Of:
a) 100% Of The Tax Due For The Current Year, Or
b) 100% Of The Tax Shown On The Tax Return For The Prior Tax Year. *This Paragraph b) Does Not Apply If The Prior Tax Year Did Not Cover 12 Months,* ***Or*** *If A Tax Return Was Not Filed For The Prior Year Showing A Tax Liability (6655(d)(1)(B)(ii), Or If The Corporation Is A "Large" Corporation (IRC 6655(d)(2)).* (3), (4)

(2) *Penalty For Late Payment Of Installment Tax.*
Among Other Penalties, The Tax Code Levies Penalties For Late Filing Of A Tax Return, Late Payment Of Tax Due With The Return And Late Payment Of Installment Tax. The Penalty For Late Payment Of Installment Tax Is Computed Under The Interest Rate Rules Of Code Section 6621.

(3) *Annualized Or Seasonal Income*
A Separate Set Of Rules Permits Lower Installment Payments Where Annualized Income Or Seasonal Income Installments Are Less. (IRC 6655(e)). This Can Be Beneficial In The Case Of Canadian Corporation Incurring A One-Time Sale Of US Real Estate.

(4) *Short Taxable Year.*
No Installment Tax Payment Is Required If The Taxable Year Is Less Than 4 Full Calendar Months. If The Taxable Year Is At Least 4 Months But Is Less Than 12 Months The Regular Due Dates Described Above Apply.

CANADIAN RESPs AND TFSAs OWNED BY US CITIZENS AND US RESIDENTS

Readers are aware IRS Forms 3520 and 3520-A must be filed by a US citizen or US resident (including a green card holder living in Canada) if he/she "owns" or receives a distribution from, a non-US trust. Separate rules apply to RRSPs and RRIFs.

Under US rules, the individual setting up and transferring funds to a Canadian Registered Education Savings Plan (RESP) or Tax Free Savings Account (TFSA) may be considered the owner of a non-US trust. Thus a US citizen or US resident (including a green card holder living in Canada) may be required to file IRS Forms 3520 and 3520-A for each RESP and TFSA which he/she owns, or from which he/she receives a distribution.

As a reminder, the penalty for failure to **timely** file these Forms is the **greater** of $10,000 or 35% of the distribution from the trust, and 5% of the amount in the trust. Forms 3520 and 3520-A are considered timely filed if they are filed by the due date (or the extended due date of the return, provided the extension Form is timely filed).

Unlike Form 3520 which is originally due April 15th (June 15th for certain individuals), Form 3520-A is due March 15th. Thus, filing an extension by March 15th can easily be overlooked due to the focus on the April 15/June 15 original due date for income tax returns (Form 1040) and Form 3520.

CANADIAN IRREVOCABLE TRUSTS MAY NOT BE APPROPRIATE FOR US RENTAL PROPERTY?

Much has been written, and commented upon, with respect to the use of a Canadian irrevocable trust to purchase a US personal residence. Beware however, such a structure may not be suitable for the purchase of US rental real estate. This stems from the difference between the US tax rate on capital gains compared to the US tax rate on "ordinary" income.

In the case of a personal use residence, there will often be no annual income in such trust. There would only be a "capital gain" (or loss) for US tax purposes at the time of sale of the residence. At the moment, the maximum US tax rate on the trust's gain on the sale of the personal use residence is about 15% provided the residence was owned for more than a year by the trust.

However in the case of rental income the federal tax rate on the trust is 39.6% of the "taxable income" exceeding $7,500. Therefore it may be unwise wise to let rental income accumulate in a trust. Simplistically, if all the ordinary "income" in the trust is paid out annually to the beneficiaries there will be no income tax in the trust. However the beneficiaries will be required to file a US income tax return and report their proportionate share of the trust's "income" distributed to them.

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