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

4710 NW 2ND AVENUE, #101, BOCA RATON FL 33431 / TEL 561-241-9991 / FAX 561-241-6332 / RB@TAXINTL.COM / WWW.TAXINTL.COM

WINTER / SPRING, 2011 / VOL. 27, NO. 1

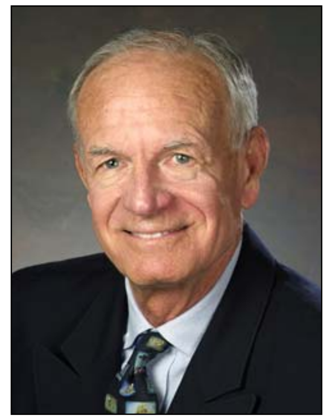
A New (Additional) Penalty For Late Filing of IRS Forms 5471 and 3520.

Readers are aware a penalty of $10,000 potentially applies to the late filing of each required IRS Form 5471 when a US citizen, US resident, US corporation, etc., (the "taxpayer") has a certain involvement directly or indirectly with a specified non-US corporation. A similar penalty may apply when such a taxpayer fails to file IRS Form 3520 with respect to the transfer of funds to, or the receipt of a distribution from, a non-US trust.

Now, a recent change in the tax law extends the (generally) three year statute of limitations period for the taxpayer's income tax return if one or more of the above Forms is required but not filed. The three year period of limitations will not commence until any applicable required Forms 5471 and 3520 are filed. Thus the IRS will potentially have an unlimited time period to assess a prior tax return if the Forms are not filed. (IRC §6501(c)(8)).

Taxpayer Allowed to Re-Elect Foreign Earned Income Exclusion

Under the normal tax code rule an individual who revokes the "foreign earned income exclusion" cannot re-elect the exclusion before the 6th year thereafter without approval of the IRS. Reg.§1.911-7(b)(2) provides examples of some relevant facts that may result in the IRS approving an early re-election. In Letter Ruling 201105011 the IRS approved an early re-election when an individual moved from one country to another within the 6 year period and experienced a substantially higher income tax rate.



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 40 YEARS.

Nexus Caution - When Franchising Your Product or Service in the US

The Supreme Court of Iowa has determined the KFC Corporation was subject to Iowa income tax even though KFC owned no restaurants in Iowa and had no employees in Iowa. The court decided that KFC was liable for Iowa income tax because of its use of intangibles within Iowa - i.e. the licensing of KFC restaurants within Iowa. (KFC Corporation v. Iowa Department of Revenue, Iowa Supreme Court, No. 09-1032, December 30, 2010).

Exception to Electronically Filing US Income Tax Returns

Generally, tax return preparers who expect to file an aggregate of 100 or more Forms 1040, 1040A and 1041 tax returns during calendar year 2011 must file them electronically. However, in cases where the taxpayer (not the preparer) chooses not to file electronically, IRS Form 8948 must be completed and filed with the paper tax return.

Corporate Income Tax Nexus in New Jersey

An out-of-State taxpayer that solicits business within New Jersey or derives receipts from sources within New Jersey is considered

MAIN OFFICE • 4710 N.W. 2ND AVENUE, SUITE 101 • BOCA RATON, FLORIDA 33431, U.S.A.
TEL (561) 241-9991 • FAX (561) 241-6332 • E-MAIL RB@TAXINTL.COM • WWW.TAXINTL.COM

to have nexus in New Jersey for purposes of New Jersey's corporation business tax (CBT). (New Jersey Technical Advisory Memorandum TAM-6, January 10, 2011).

Kentucky Sales Tax on Prewritten Computer Software

The Kentucky Court of Appeals has determined that sales tax applies to the purchase of licenses to use prewritten computer software for a 60 month term. The purchase included the hardware to operate the software. (Computer Services Inc, v. Finance and Administration Cabinet, Dept of Revenue, Kentucky Court of Appeals, No. 09-CI-00118, January 7, 2011).

"Click-Through" Nexus Rule Becoming Popular

We previously mentioned several States that have implemented a form of the "click-through" nexus rule to enable States to collect sales tax from out-of-State sellers even though the seller has no actual physical presence in the State, as required by federal law. Several additional States have continued to propose or implement such legislation, some of the latest being Illinois, Alabama and Arkansas.

For example, beginning July 1, 2011, an out-of-State retailer would be considered to maintain a place of business in Illinois if, generally, the out-of-State business has a contract with a person in Illinois who receives a commission by referring customers via a link on the Illinois person's website. A similar rule will apply to servicemen.

Exemptions apply in each case if the aggregate transactions during a prescribed time period fall below a minimum.

IRS Issues Relief from Electronic Filing for Certain Tax Return Preparers

Generally, tax return preparers who file more than 100 individual income tax returns for the tax year 2010 (excluding Form 1040NR), must file them electronically. The rules will likely tighten further for the 2011 tax year. However, the IRS has issued Form 8944 to give certain preparers an opportunity to apply for a hardship exemption. Forms 8944 mailed or faxed after April 1, 2011, will only be reviewed under limited circumstances.

Electronic Payment Required for Certain US Tax Payments in 2011

Small and certain medium sized businesses often previously made their tax payments (e.g. payroll tax, and corporate estimated (installment) tax payments, at their US bank or by mail addressed to the "Financial Agent" with IRS Deposit coupon 8109-B. However, beginning January 1, 2011, the IRS no longer accepts coupon 8109-B and all payments previously made with this coupon must now be made electronically from a United States bank or "same day wire" from a US bank. Thus many Canadian corporations must set up an Electronic Funds Transfer Payment System ("EFTPS") account online with the IRS (and open a US bank account if they do not already have one).

Gambling Losses Disallowed Due to Insufficient Documentation

Nonresident aliens are taxed on most US gambling winnings. However, the tax treaty provides that Canadians can deduct certain losses from winnings before the tax is calculated.

In a recent case a recreational gambler was denied a deduction for losses because he did not maintain a diary or other record of losses. At his trial he could only provide a theory to explain how he calculated the deduction. (W. Jones, T.C. Memo 2011-77).

Different Rules for Residency of a Trust

For Canadian income tax purposes the residence of a trust is determined on the basis of where the central management and control of the entity exists. (Garron v. The Queen, DTC 1287 (T.C.C.) This conflicts with an earlier case where the residence is the location of the majority of the Trustees. (Thibodeau Family Trust v. The Queen 78 DTC 6376 (F.C.T.D.). The Federal Court of Appeals upheld the Garron decision.

For United States income purposes a trust is a US (domestic) trust if:

1) a court within the United States is able to exercise primary supervision over the administration of the trust, and

2) one or more United States persons have the authority to control all substantial decisions of the trust.

Article IV of the treaty states the status of "dual resident" trusts will be determined by the Competent Authority.

New IRS Voluntary Disclosure Program for Offshore Income

The IRS has introduced an additional special voluntary compliance (amnesty) program for US persons who have unreported offshore income, accounts, foundations, trusts or entities. (OVDI). Participants must become fully compliant for the years 2003 through 2010 by August 31, 2011. There is a higher penalty structure than the first amnesty program (OVDP) that ended October 15, 2009.

South Dakota Starts Potential New Trend for States

Out-of-State retailers which are not registered in South Dakota to collect and remit sales and use tax, but sell tangible personal property, services, or products transferred electronically for use in South Dakota, are required to notify their buyers that they (the buyers) must pay and report South Dakota "use tax" on their purchases.

Among other things the Notice must be readily visible and must advise the buyer that the purchase is not exempt from South Dakota use tax merely because the purchase is made over the Internet, by catalog, or by other means. (S. B. 146 Laws 2011, effective July 1, 2011). A de mimimis exemption exists, as in the "click through" nexus rules previously described.

It has long been the case that all such buyers, in all States that levy a sales tax, are subject to such a contingent "use tax" liability if the sales tax is not paid by the seller. However, many (most?) buyers have either been unaware of this "use tax" liability or ignored it. The "Notice" that is now required to be given to the buyer may have a more chilling effect on many buyers considering online purchases. Alabama is also considering such legislation. Perhaps other States will follow.

California Sends out Warning To 300,000 Business Owners

The California Board of Equalization has notified approximately 300,000 service business owners that they may owe "use tax". The rules could apply to Canadian enterprises doing business in California. For more information see News Release 41-11-H California State Board of Equalization, March 14, 2011.

Qualified Personal Residence Trust Does Not Work In NY

Simplistically, a US residence can be transferred to a "Qualified Personal Residence Trust" (QRPT) under terms by which the transferor gives the remainder interest in the residence to the beneficiary while the transferor retains the right to use the property. The procedure is intended to enable the transferor to be subject to US gift tax only on the value of the remainder interest while potentially avoiding estate tax on the property.

However, New York State recently levied estate tax on the entire value of the residence because the transferor/decedent's death occurred during the "initial term" of the trust. (The transfer was not considered to be fully effective until death of the transferor because the transferor (decedent) retained possession or enjoyment of income derived from the property at the time of his death). (TSB-A-10(3)M, NY Commissioner of Taxation and Finance, August 5, 2010).

California Imposes New Tax Rules on Out-of-State Businesses

For tax years beginning after December 31, 2010, California will require Canadian and other out-of-State corporations to file a California return and pay a minimum tax, if it:

1) Actively engages in **any** transaction for the purpose of gain or profit in California, **or**

2) Meets **one** of the following bright-line factor based thresholds:

a) the amount paid in California by the taxpayer for compensation exceeds the lesser of $50,000, or 25% of the total compensation paid by the taxpayer, **or**

b) the taxpayer's California sales, including sales by an agent or independent contractor exceed the lesser of $500,000, or 25% of the taxpayer's total sales using special apportionment rules, **or**

c) the taxpayer's California real property and tangible personal property exceed the lesser of $50,000, or 25% of the taxpayer's total real property and tangible personal property.

A Canadian or other out-of-State business that has less than the threshold amounts of property, payroll, and sales in California may still be considered doing business in California if the taxpayer actively engages in any transaction for the purpose of gain or profit in California. For example, if you have an employee that works from his/her home in California doing warranty work in California you would be considered doing business in California even if you are below all the above enumerated thresholds. (*General Information on New Rules for Doing Business in California*, California Franchise Tax Board, March 4, 2011).

Dramatic US "Red Tape" in 2013 For Canadian Banks and Brokerages

Effective January 1, 2013, the "Foreign Account Tax Compliance Act ("FATCA") requires each participating "foreign financial institution" ("FFI") (for example each participating Canadian bank, brokerage firm, mutual fund, investment corporation, and some family trusts), to require each account holder (including of course those living in Canada) to state, under penalty of perjury, whether he or she is a US person. The reporting will also apply to non-FFIs (for example US entities) which have a 10% or more US owner.

Each participating FFI will report each American's income to the IRS in the same manner now done by US banks - generally a version of IRS Form 1099.

Why would an FFI agree to participate? An FFI that does not participate will have 30% US tax withheld at source on every item of US income paid to the institution and all proceeds on dispositions of US assets (e.g. US stocks). Thus to avoid the 30% withholding the Canadian bank or brokerage could refuse to do business with US citizens, including those living in Canada, or could refuse to purchase US securities for any of their clients.

Exception - If the total of the client's accounts is under $1 million and there is no indication of US ownership, (or the value of the account is under $50,000), the above rules will not apply. (Will future legislation tighten the exceptions?).

South Carolina Introduces Sales Tax Nexus Safe Harbour Bill

Legislation has been introduced in South Carolina that would establish that ownership or use of a distribution facility in South Carolina would not constitute physical presence for "nexus" purposes for South Carolina sales tax, provided all conditions are met.

IRS Announces its First "Smartphone"Application

The IRS has introduced the free "IRS2GO" phone app which works with iPhone and Android phones and permits taxpayers to check the status of their tax refund. E-filers can use the app within 72 hours after receiving an IRS email confirming the IRS received the tax return. Taxpayers who file paper returns must wait 3-4 weeks before they can use the phone app.

Corporation's Shareholder Personally Liable for Corporation's Unpaid State Income Tax

A Colorado court held that the sole shareholder of a dissolved corporation was liable for the corporation's unpaid Colorado State income tax because the shareholder received assets in the liquidation that could be claimed by a creditor under Colorado law. (J.F. Holmes, DC Colo).

Community Property States

Individuals who live in a US community property State may generally be required to include the community property share of their spouse's income. An exception may occur if the couple executed a premarital agreement designating certain property to be separate property.

In a recent Arizona case the wife was required to include in income her community property share of her husband's wages, dividends, unemployment compensation, and gain from the sale of stock but was permitted to completely exclude the social security benefits received by her husband and personal injury settlement proceeds received by her husband. Other exceptions also applied. (Oliver, TCM Memo 2011-43).

US ESTATE TAX RULES FOR 2010, 2011 AND 2012

RULES FOR 2010

This article addresses only issues applicable to individuals that are not US citizens, and not domiciled in the US for estate tax purposes (Nonresident Noncitizens - "NRNCs"). Additional complexities may apply for US citizens and US domiciliaries.

Subscribers are aware that originally the estate tax law for 2010 provided that no individuals dying in 2010 (Canadian or otherwise) were subject to United States federal estate tax. In effect there was no federal estate tax in existence for 2010.

However, that rule has been modified retroactive to January 1, 2010! In other words, the estates of some Canadian NRNCs who died in 2010 will still be subject to US estate tax if they are not alert!

Beware Estate Tax Rules for 2010 There is Estate Tax... Unless...

Until December 17, 2010, the pertinent US legislation provided that there was no US federal estate tax applicable to any estate of any individual (Canadian or otherwise) dying in 2010. However legislation enacted December 17, 2010, modified that rule retroactively to January 1, 2010.

For 2010 the estate tax rules applicable to 2011 and 2012 (described below) apply retroactively to January 1, 2010 unless the Estate elects by a deadline to have the original (no tax) rule apply for 2010.

Thus there is no automatic exemption from US estate tax for Canadians dying in 2010 unless the prescribed election is made. There is a deadline for making the election. The law provides that unless the election is made to use the original 2010 (no tax) rule within the later of 9 months from December 17, 2010, or the date of death, the rules for 2011 and 2012 will apply to 2010 and there could be estate US tax payable for a Canadian who died in 2010!

However, please see the comments regarding IRS Form 8939 in the next column.

Electing To Have The 2010 "No Tax" Legislation Apply. As we go to press it is not clear (the IRS has not given definitive guidance), with respect to how this "no tax" election is to be made for 2010 other than issuing a draft of new IRS Form 8939.

In the case of the death of NRNCs in 2010 the executor of an estate whose US assets exceed $60,000 is required to make a return to the IRS containing a large amount of information on the US property transferred to heirs. (IRC §6018). The IRS has issued a 3 page draft of a Form for this purpose which has not been finalized as we go to press (draft IRS Form 8939 - "*Allocation of Increase in Basis for Property Acquired from a Decedent*") which some practitioners believe will comprise part or all of the election.

Please sign up at our website for our "Free US International Tax Alerts" and we will alert you when further guidance has been issued by the IRS on making the election and completing IRS Form 8939. It is also unclear whether an executor who does not choose to have the 2010 "no tax" rule apply will still be subject to the reporting requirements of Form 8939. A reduced amount of the information on Form 8939 must be supplied to each beneficiary.

Although the law states Form 8939 must be filed, and the information must be supplied to the beneficiary, within the later of 9 months from December 17, 2010 or the date of the 2010 death, the IRS has advised it will allow a reasonable period of time for filing Form 8939 after the form has been finalized. According to new Code Section 6716 there is a $10,000 penalty for any Executor who fails to timely file IRS Form 8939.

Please contact your tax advisor before taking any action.

US Cost Basis (ACB) Rules for Deaths in 2010

1) If you **do not** make the election under Form 8939 to have the original (no tax) rule apply then the heir(s) to the estate will generally receive a "step up" in cost base for US income tax purposes of the property they inherit to the fair market value at the date of death (or in some cases 6 months later).

2) However, **if you do** make the election under Form 8939 to have the original (no tax) rule apply then "modified cost basis" (modified ACB) rules apply. In this case there is no estate tax, however, there are special rules with respect to determining the US cost basis of property acquired by an heir to the estate. In fact, because of these special cost basis

rules, it could be preferable for some Canadians to forego making the election on Form 8939 to use the 2010 "no tax" rule.

Under the "modified cost basis" rules (which apply only to 2010 deaths) an heir will generally have a cost basis for US purposes equal to the lesser of:

1) The cost basis of the decedent, or

2) The fair market value at the date of death. (IRC §1022(a)).

However, under Code Section 1022(b)(2)(B) the basis can be increased by $60,000 for the estates of nonresident non citizen decedents (potentially up to $1.3 million for others).

In addition, there is a potential spousal basis increase in an amount up to $3 million for "qualified spousal property". In either case the basis cannot be increased beyond its fair market value (IRC §1022(d)(2)). There is no indication in Section 1022 that property passing to a nonresident alien surviving spouse is denied status as "qualified spousal property", however, we may hear more about this.

Under IRC §6018 certain returns are required to be made with respect to cost basis for heirs under the "modified cost basis" rule and under IRC §6716 a potential penalty of $10,000 may apply for failure to comply.

This article only addresses NRNCs but the estates of US citizens and US domiciliaries should be aware they have a potential $1.3 million increase in cost base if the 8939 election is made, plus an additional potential cost basis increase of up to $3 million for "qualified spousal property that passes to a surviving spouse (IRC 1022(c)), limited of course to the fair market value of the property at the date of death. (IRC §1022(d)(2)).

The rules above apply only to deaths in 2010. A completely different set of rules applies for deaths in 2011 and 2012.

For guidance the IRS has issued Publication 4895 (Basis of Inherited Property Held by Decedents Who Died in 2010). Please contact your tax advisor before taking any action.

RULES FOR 2011 & 2012

The new US federal estate tax and gift tax legislation which was enacted December 17, 2010, dramatically changes the US estate tax rules for deaths in 2011 and 2012. The legislation also changes the rules for deaths in 2010 (see **RULES FOR 2010**, above).

For 2011 and 2012 (and also for 2010 when IRS Form 8939 is not timely filed) the US estate tax applies, there is an inflation adjusted "exemption" of $5 million for US citizens and US domiciliaries, and the top estate tax rate is reduced to 35%.

Readers are aware that technically there is not an "exemption" of $5 million. The way the law actually reads, there is a "unified tax credit" of $1,730,800 which has the effect of offsetting the estate tax applicable to the first $5 million of taxable estate. Under the Canada/US tax treaty NRNCs who are resident in Canada are entitled to a proportion of this $1,730,800 (2011) tax credit depending on the proportion of their worldwide assets that are subject to US estate tax.

Any portion of a deceased spouse's potential "unified tax credit" that is not used in the deceased spouse's estate (i.e. not required to offset tax in the deceased spouse's estate) is referred to as the deceased spouse's "unused exclusion amount" and is "portable" - i.e. it can be potentially carried forward and used by the estate of the surviving spouse when he or she dies. (IRC §2010(c)(2)).

Further, for certain Canadians a "marital tax credit" in an amount up to the amount of the "unified tax credit" is also available under the tax treaty. Thus a total of $3,461,600 in tax credits against US estate is potentially available to Canadian NRNCs.

Since the maximum tax rate on all decedents is capped at 35%, the combined potential total tax credits of $3,461,600 result in the fact there will potentially be no estate tax on a deceased Canadian with less than approximately $9,900,000 in worldwide assets provided the US property goes to the surviving spouse and there were no prior US taxable gifts. Of course an evaluation must then be made of the surviving spouse's exposure to estate tax.

Unfortunately, as in the case of prior law, the existing law for 2011 and 2012 described above sunsets (terminates) at the end of 2012. Thus no-one knows what the estate tax rules will be for 2013 and beyond, and there will likely be more tough political negotiations over estate tax a few years from now.

US Cost Basis (ACB) Rules for Deaths in 2011 & 2012

For deaths occurring in 2011 and 2012 the cost basis of assets acquired by heirs will generally be the fair market value at the date of death (or six months thereafter if elected).

For the cost basis of property received via deaths in 2010 please see **"US Cost Basis (ACB) Rules for Deaths in 2010"** above.

US GIFT TAX RULES FOR 2010, 2011, AND 2012

US taxable gifts made by nonresident noncitizens in 2011 are generally subject to an annual exclusion of $13,000 per donee. However, gifts to a nonresident alien spouse in 2011 are subject to an exemption of $136,000 and gifts to a US citizen spouse are generally not subject to gift tax. Gifts above the exclusion amount are subject to a maximum 35% tax.

For 2011 and 2012, for US citizens and US domiciliaries, the tax on the first $5,000,000 of taxable gifts can be offset against the $5 million estate tax "exemption". For 2010 only the tax on the first $1 million of taxable gifts can be offset by the $5 million estate tax "exemption".

CANADIANS TEMPORARILY WORKING IN THE US - APPLICABILITY OF US UNEMPLOYMENT TAX

We previously summarized the US income tax rules for non-US citizen Canadians temporarily working in the US. Also we summarized the US social security tax rules for such individuals that are provided under the Canada/US Social Security Totalization Agreement.

However, the US law includes a separate unemployment tax that is not covered by the income tax rules or the Totalization Agreement. Thus, Canadian employers of Canadians temporarily working in the US are potentially required to pay US unemployment tax on these employees.

To avoid double taxation, Canada and the US entered into an agreement attempting to provide an exemption for certain employees. *("Agreement Between the Government of Canada and the Government of the United States of America", effective 1942 and amended in 1951).*

Under the Agreement, the Canadian employer of an individual working temporarily in the US may be required to pay US unemployment tax if:

1) The individual's services are "localized" in the US, or

2) The services are not localized in any jurisdiction but some of the services are performed in the US, and

i) The individual's base of operations, or if he/she has no base of operations, the place from which the services are directed or controlled, is in the US, or

ii) The individual's base of operations or the place from which his/her services are directed or controlled, is not in the US but his/her residence is in the US.

Services are deemed "localized" within a jurisdiction if:

a) Such services are performed entirely within such jurisdiction, or

b) Such services are performed both within and without such jurisdiction, but the services performed outside such jurisdiction are incidental to the individual's services performed within such jurisdiction, (for example they are temporary or transitory in nature, or consist of isolated transactions).

MORE NEGATIVES FOR US CITIZENS & US RESIDENTS WITH PFICs

We have often mentioned the potentially negative US tax consequences for US citizens and US residents (including green card holders living in Canada) who own certain non-US mutual funds, and certain non-US trusts that are not operating businesses (and are not truly "passive" trusts as defined under US tax law). Many of these entities appear to be Passive Foreign Investment Companies - "PFICs" - under US tax law.

An ownership interest in a PFIC can be difficult to dispose of without experiencing the negative US tax effects which we described in prior Taxletters. Further, the longer you own the PFIC the worse the US tax result may become - assuming the PFIC appreciates in value above your purchase price.

Among other circumstances, you are subject to the US PFIC rules if you "dispose" of the PFIC. Unfortunately the word "dispose" has a very broad definition. You may be considered to have disposed of a PFIC if there is a direct, indirect or "deemed disposition" of the PFIC.

Rather shockingly, you may be deemed to have disposed of a PFIC if you use it as collateral for a loan. Thus, for example, if your non-US mutual fund is in a margin account in a Canadian brokerage firm, you may be deemed to have disposed of the mutual fund (PFIC). (IRC §1298(b)(6)).

Also, pursuant to its authority under Section 1291(f) the IRS has issued proposed regulations which would cause the PFIC rules to also apply if you give your PFIC to another individual, or if there is a transfer by reason of death, unless it passes to a US person. (Prop Reg. 1.1291-6).

Thus, for example, the PFIC rules may apply if you die while owning a PFIC. This could involve a substantial interest charge (in addition to tax) if the PFIC had appreciated substantially and you had owned it a long time.

Also, the disposition of a PFIC by an intermediate entity is treated as a disposition by the US investor. Further, if an intermediate entity owns a PFIC and any US investor in the intermediate entity disposes of his/her interest in the intermediate entity the US investor in the intermediate entity might have US tax consequences. (See Proposed Reg. §1.1291-3(e)(2)(ii)).

And beware, under certain "look through" rules you may be an investor in a PFIC even if you do not realize it. (IRC §1297(c)). If a foreign corporation owns (directly or indirectly) at least 25% (by value) of the stock of another corporation, for purposes of determining whether such foreign corporation is a PFIC, such foreign corporation shall be treated as if it:

1) Held its proportionate share of the assets of such other corporation, and

2) Received directly its proportionate share of the income of such other corporation.

Certain exceptions to the PFIC rules apply such as:

1) The exchange of PFIC stock for other PFIC stock (Prop Reg. §1.1291-6(c),

2) A gift to a US person (of course the transferee US person now has the PFIC problem),

3) A transfer to a partnership (complex rules apply), or

4) The gift by a US person to a nonresident alien spouse who has made the election under §6013(g) to be treated as a US resident. (The termination of the election will be treated as a disposition of the stock).

Other rules and exceptions apply - please contact your tax advisor before taking any action.

Beware - all these rules may also apply to PFICs held in Canadian Registered Education Savings Plans (RESPs) and Tax Free Savings Accounts (TFSAs) - and also to PFICs held in RRSPs and RRIFs for which the tax treaty Article XVIII(7) election has not been made.

THE IMPORTANCE OF THE TREATY "LOB" ARTICLE

To prevent individuals from non-treaty countries from "treaty shopping" - i.e. preventing a nonresident alien who is a citizen and resident of a country with which the US does not have a tax treaty (e.g. Bolivia) from forming a US corporation to invest in Canada (or a Canadian corporation to invest in the US) to obtain treaty benefits, the Canada/US tax treaty contains Article XXIXA ("Limitation on Benefits" - LOB) which limits the benefits of the treaty to certain "qualifying persons" and to other persons under an "active trade or business" exception.

A "qualifying person" includes natural persons, governmental entities, estates, certain not-for-profit entities, and charitable or pension related entities, that are residents of Canada or the US.

A "qualifying person" also includes certain (but not all) corporations and trusts that are resident in Canada or the United States. Please see Article XXIXA for extended rules. Please see the Winter/Spring, 2009, Taxletter for related rules associated with whether an entity is treated as a resident of one of the countries for treaty purposes.

Thus, for example, a Canadian person making interest, dividend, or royalty payments to a US address may technically be required to determine if the recipient is a "qualifying person" before applying reduced treaty withholding rates.

For further restrictions on the use of the tax treaty please see the article ***"BEWARE THE TAX TREATY "SAVING CLAUSE."***

FINAL "FBAR" (FORM TDF 90-22.1) RULES ARE ISSUED

On February 24, 2011, the "final" rules for completing Form TDF 90-22.1 (Foreign Bank Account Reporting - "FBAR") were issued.

Readers recall certain individuals and entities which have a "financial interest" in, or "signature or other authority over", a "foreign account" are required to file the FBAR if the aggregate maximum balance in all the accounts exceeds $10,000 at any time during the calendar year. The Form must be received by the US Treasury by June 30 of the following year. It is not sufficient to be postmarked by June 30, and there are no extensions. At the moment electronic filing is not available but the Treasury has plans to arrange such filing.

An important revision to the original regulations (31 C.F.R. Section 103.24, - now changed to 31 C.F.R. 1010.350) is its effect on certain Canadians that are not US persons. The original rules required Canadians and Canadian businesses that were "*in, and doing business in*", the United States to file Form TDF 90-22-1 even if they were not US persons. This requirement has been removed. Now, only US persons have this "FBAR" filing requirement.

Nonetheless, the definition of "US person" for FBAR purposes is broader than the definition of "US person" for US income tax purposes. For FBAR, a US person is an individual who is a citizen or resident of the US, or an entity formed under laws of the US, any State, the District of Columbia, the Territories, and Insular (Island) possessions of the US or the Indian Tribes. Thus a trust formed in the US is a US trust for purposes of FBAR even if it is a foreign trust under US income tax rules.

Special rules are provided for an individual who becomes a US resident during the year. A non-US person does not become a US person simply by making an election to file a joint tax return with a US resident spouse under Code Section 6013(g) or 6013(h)).

All green card holders are subject to the FBAR rules, even those who elect to file their US tax return as a nonresident under a treaty.

The foreign "financial accounts" required to be reported on Form TD F 90-22.1 include (but are not necessarily limited to) bank accounts, securities accounts, insurance policies with a cash surrender value, annuities, and mutual funds.

Financial Interest

A "financial interest" exists if you are the owner of record or have legal title, whether the account is maintained for you or the benefit of others.

A US person also has a "financial interest" in an account for which the owner of record or holder of legal title of the account is:

1) A person acting as agent, nominee, attorney, or in some other capacity on behalf of a US person with respect to the account,

2) A corporation in which the US person owns directly or indirectly more than 50% of the voting power or the total value of the shares,

3) A partnership in which the US person owns directly or indirectly more than 50% of the interest in profits or capital,

4) A trust, if the US person is the trust grantor, and has an ownership interest in the trust for US income tax purposes,

5) A trust in which the US person either has a present beneficial interest in more than 50% of the assets or from which the person receives more than 50% of the current income, or

6) Any other entity in which a US person owns directly or indirectly more than 50% of the voting power, total value of the equity interest or assets, or interest in profits.

There is a simplified filing available to persons with financial interests in 25 or more accounts.

Signature or Other Authority

"Signature or other authority" means the authority of an individual (alone or in conjunction with others) to control the disposition of money, funds, or other assets held in a financial account, by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained. Such US persons must file FBAR even if they have no "financial interest" in the account. Some exceptions apply including an officer or employee of certain entities either registered with the SEC or with a class of equity securities that is listed on any US national securities exchange.

There is a simplified filing available to persons with signature authority but no financial interest in 25 or more financial accounts.

For more reporting trouble coming for US persons in 2011 please see the article "***MORE REPORTING REQUIREMENTS COMING FOR US PERSONS FOR 2011***".

MORE REPORTING REQUIREMENTS COMING FOR US PERSONS FOR 2011

We previously mentioned that the FBAR rules described above are not part of the Internal Revenue Code. They exist in Section 31 of the "United States Code" (USC). The Internal Revenue Code is in Title 26 of the USC.

However, for 2011 a new Section of the Internal Revenue Code itself has been enacted that will somewhat duplicate the information required for FBAR but the requirements may be even broader.

New Internal Revenue Code Section 6038D states any individual holding any interest in a "specified foreign financial asset" must attach to his/her US income tax return for 2011 certain information with respect to each such asset if the aggregate value of all such assets exceeds $50,000 (or such higher value as the Treasury may prescribe).

To the extent provided in regulations the requirements will apply to domestic entities and **nonresident aliens**. (IRC §6038D(h)(2)).

The potential penalty for noncompliance is $10,000.

A "specified foreign financial asset" means:

1) Any financial account (as defined by Section 1471(d)(2)) maintained by a foreign financial institution, and

2) Any of the following assets not held in an account maintained in a financial institution:

a) Any stock or security issued by a person other than a US person (e.g. shares of a Canadian corporation),

b) Any financial instrument or contract held for investment that has an issuer which is not a US person, and

c) Any interest in a foreign entity (as defined in Section 1473).

BEWARE THE TAX TREATY "SAVING CLAUSE"

When faced with a cross border taxation issue, tax practitioners are aware it is dangerous to automatically jump to the purportedly relevant Article of the tax treaty and draw a conclusion from there on the correct tax treatment of the transaction. However, many Articles in the treaty do not apply to residents of Canada or the United States, or to US citizens.

Specifically, Article XXIX, paragraph 2 of the treaty states "*except to the extent provided in paragraph 3, this Convention shall not affect the taxation by a contracting state of its residents …………and, in the case of the United States, its citizens ……………….*".(emphasis supplied).

Thus, it is necessary, perhaps most commonly in the case of US tax matters for US citizens and US residents, to examine paragraph 3 of Article XXIX, before drawing any conclusions with respect to any other Article of the treaty.

For example, only limited portions of Article XIII addressing "gains" apply to the US taxation of US citizens and US residents, and paragraph 6(a) of Article XVIII addressing alimony income does not apply to the US taxation of US citizens and US residents.

Interestingly Article IV (residency) of the treaty is not included in Article XXIX(3) as a provision applying to US citizens. However we have been advised informally by the IRS that Article IV would be applicable to a US citizen in some circumstances.

For further restrictions on the use of the tax treaty please see the article "***THE IMPORTANCE OF THE TREATY "LOB" ARTICLE***".

DEADLINE FOR THE "FOREIGN EARNED INCOME EXCLUSION"

US citizens and green card holders who work and reside outside the US can potentially make an election to exclude a portion of their "earned income" from US tax. The exclusion is elected by filing IRS Form 2555 with the income tax return.

To obtain the exclusion, a valid election must be made (Form 2555 must be filed):

1) With an original income tax return that is timely filed, or

2) With an amended return, filed within the period allowed for amending the foregoing timely filed return, or

3) With an original income tax return not timely filed, but filed within one year after the due date, (without regard to extensions), or

4) If the taxpayer does not owe any federal income tax (after taking into account the exclusion), the election can be made with an original income tax return filed any time after one year following the original due date (without regard to extensions) and either before or after the IRS discovers the taxpayer failed to elect the exclusion, or

5) If the taxpayer does owe federal income tax (after taking into account the exclusion) the election can be made with an original income tax return filed any time after one year following the original due date (without regard to extensions) *provided it is filed before the IRS discovers that the taxpayer failed to elect the exclusion*.

A taxpayer filing under the circumstances of either 4) or 5) must include the following at the top of the first page of the tax return: "***Filed pursuant to Section 1.911-7(a(2)(i)(D)***". In determining whether there is "any tax due" the taxpayer is allowed to consider payments such as tax withheld, estimated tax, and tax credits.

Thus, in most cases a taxpayer can make the election at any time provided:

a) there is no tax due, or

b) the election is made before the IRS discovers it has not been made; as long as the general statute of limitations has not passed.

If there *is* tax due and the IRS discovers it before the election is made you can still a seek an extension of time under Reg. 301.9100-3 if you can provide evidence that you acted reasonably and in good faith, and the grant of relief will not prejudice the government.

CAUTION FOR CANADIANS WITH A US RESIDENCE OWNED BY US CORPORATION

Readers are aware, in the past the Canada Revenue Agency (CRA) had an informal administrative concept referred to as a "single purpose corporation" whereby Canadians who were nonresident aliens of the United States could own their US residence through a Canadian corporation and be able to avoid US estate tax as well as a shareholder benefit being assessed by CRA, provided the corporation was properly operated.

CRA discontinued this policy after certain estate tax changes were made to the Canada/US tax treaty, but existing structures were grandfathered under certain circumstances.

Although it would be rare for a Canadian individual to own a US personal use residence through a United States corporation, such an individual should beware doing so without paying market-based rent to the corporation. Absent the payment of market-based rent to the US corporation the IRS would likely consider there to have been a deemed distribution to the shareholder based on the fair market value of the rent. (Revenue-Ruling 58-1).

The amount of the deemed distribution would be taxable to the shareholder if the corporation had current or accumulated "earnings and profits". (Please see the article "***IMPORTANCE OF THE "EARNINGS AND PROFITS" COMPUTATION***"). The corporation could have current or accumulated earnings and profits if, for, example, it had rental or business profits in the corporation during the current or prior years.

If the corporation does not have current or accumulated earnings and profits the deemed distribution would be treated as a return of capital thus reducing the Canadian's cost base of the shares of the corporation. If the corporation is liquidated after a reduction in the cost base and while it still owns the residence there could be a US taxable capital gain to the shareholder on the shares, as well as US corporate income tax on any increase in value of the residence.

If the corporation is not liquidated, once the cost base has been completely recovered any further deemed distributions could be treated as a taxable capital gain to the Canadian shareholder for US purposes, if the corporation still owns the residence.

US CITIZENS/RESIDENTS AND "OFLS" & "ODLS"

We previously described the US tax concept affecting US citizens and US residents referred to as an "overall **foreign** loss" ("**OFL**)". Please see the Winter/Spring, 2008, issue of the Taxletter. If an individual has an OFL in a tax year, or as a carryforward, it can reduce his/her ability to utilize foreign tax credits on a US tax return because the OFL can cause a portion of foreign source income to be treated as US source income for purposes of computing the individual's foreign tax credit.

Another US tax concept, referred to as an "overall **domestic** loss" ("**ODL**") can also affect a US citizen or US resident when computing foreign tax credits. An ODL is created when a domestic loss offsets foreign source income during a year in which the taxpayer claims the foreign tax credit. (IRC §904(g)).

As in the case of OFLs, the taxpayer must maintain an "ODL account' and increase or decrease it annually as may be required. The effect of the ODL account is that future US source income is recaptured as foreign source income by up to 50% of the amount of the ODL account. ODL recapture increases the foreign tax credit limitation for the recapture year. It can increase tax credit utilization once the taxpayer starts to have net domestic source income.

There is an "ordering rule" when a taxpayer has both an OFL and an ODL. Domestic source losses reduce foreign source income before the overall foreign losses are recaptured. Thus the OFL and ODL accounts do not directly offset each other. (Reg. §1.904(g)-3T(e)-(g)).

IMPORTANCE OF THE "EARNINGS AND PROFITS" COMPUTATION

The are actually two important facets to the US tax concept of earnings and profits:

1) What is it?, and

2) What are the currency translation rules?

In the Fall, 2002, Taxletter in the article "***FOR U.S. CITIZENS AND RESIDENTS - THE U.S. CONCEPT OF CORPORATE "EARNINGS AND PROFITS***" we described the importance of the U.S. income tax concept of "earnings and profits" (E&P). For example, among other situations, this concept determines the U.S. tax applicable to a U.S. citizen living in Canada who receives a distribution from his/her private Canadian corporation.

The amount taxable in the US can vary from the amount taxable in Canada. The E&P computation can also affect the U.S. tax applicable to a Canadian corporation which receives a distribution from its U.S. subsidiary corporation or to a US citizen resident in Canada who receives a distribution from a Canadian Real Estate Investment Trust (REIT). In either case, the amount of income that is taxable in each country may be different.

E&P is a concept somewhat similar to net income, but with many special adjustments. The concept of E&P is intended, in part, to resemble more accurately the true economic affect on the corporation of its activities.

In general, the computation of earnings and profits must follow the method of accounting properly used in computing taxable income. Thus, a corporation using the accrual method of accounting for income taxes must use the accrual method for E&P. Generally, for US income tax purposes, US rules are used for computing taxable income of a corporation regardless of whether the corporation is a Canadian corporation or a US corporation.

Some of the differences between E&P and net income are as follows:

1) Although the corporation's income tax is deducted in computing E&P and retained earnings, complexity can arise if the corporation's accounting is on a "cash basis" - i.e. for E&P purposes, does it deduct accrued taxes, or taxes actually paid?

2) Special depreciation rates must be used for the E&P computation. For tangible property placed in service after December 31, 1986 all non-U.S. corporations must use the U.S. "alternative depreciation system" for non-U.S. assets.

3) The special extra "year of purchase" expense deduction for business property under Section 179 of the Internal Revenue Code cannot be used for E&P purposes. Instead a special 5 year amortization period is used.

4) Gain calculated on the "installment" basis for income tax return purposes must be calculated in full for E&P purposes.

5) Special rules may apply in the case of Code Section 1031 "like kind" exchanges. In Private Letter Ruling 201027036 The IRS determined (in that case) that a controlled foreign corporation (CFC) did not generate earnings and profits on a Section 1031 exchange.

6) Special rules may apply for currency translations.

The earnings and profits (E&P) of the corporation are first determined in the functional currency of the corporation (e.g. usually Canadian dollars in the case of a Canadian corporation) and then translated into US dollars at the average rate for the year. When E&P are distributed, the "accumulated E&P" in the corporation's "functional currency" (e.g. see IRS Form 5471 Schedule J) is reduced by the amount of the distribution translated at the exchange rate used to originally record that E&P. The difference between that amount and the amount of the distribution translated at the date of distribution is an exchange gain or loss to the shareholder.

Also, when a distribution of "previously taxed earnings" is made from a "controlled foreign corporation" (for example in a case where a shareholder was previously taxed on "Subpart F income") the distribution causes a reduction in the "earnings and profits" of the corporation despite the fact the distribution itself is excluded from taxation in the hands of the shareholder.

US TAXATION OF DISTRIBUTIONS FROM CANADIAN AND US TRUSTS

The US taxation of a distribution to a beneficiary from a nongrantor US (domestic) complex trust is generally simpler than the US taxation of a distribution to a beneficiary from a nongrantor non-US (foreign) complex trust. The "income" of a trust when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income determined under the terms of the governing instrument and applicable local law, not federal tax law. (IRC §643(b)).

Nongrantor Domestic Complex Trust

Taxation of the Trust. The US has a high rate of tax on income accumulated in a domestic complex trust which is intended, in part, to discourage taxpayers from transferring funds to US trusts to "split" the lower US "tax bracket" between the individual and the trust and accumulate income in the trust. The trust's income tax rate on current undistributed income is 39.6% on taxable income exceeding $7,500. (IRC §1(e). Of course certain amounts distributed to beneficiaries constitute a "distribution deduction" and reduce the trust's taxable income. (IRC §651(a)). Charitable contributions may also reduce taxable income.

In any taxable year the deduction allowed to the trust is the sum of:

1) Any amount of income for the year required to be distributed currently, and

2) Any other amounts properly paid or distributed or required to be distributed, for such taxable year.

But such deduction cannot exceed the "distributable net income" (DNI) of the trust. (IRC §661). In determining its income in the trust, the income retains its character in the same proportion entering into the computation of DNI. (IRC §661(b)).

DNI is defined generally as the trust's taxable income without deductions for distributions and the personal exemption, and increased by tax exempt interest. Further, capital gains and losses of a domestic trust are normally excluded to the extent they are allocated to corpus and are not paid or required to be distributed during the year. (IRC §643). Although capital gains earned by a domestic trust are excluded from DNI (IRC §643(a)(3)), capital gains earned by a foreign trust are included in DNI. (IRC §643(a)(6)(C)).

A domestic trust is allowed to claim a foreign tax credit against its taxable income under the normal rules of Section 901 except for the portion of taxable income allocated to beneficiaries. (IRC §642(a)). If a portion is allocated to a beneficiary it is likely the beneficiary may take the foreign tax credit. (Rev-Rul 56-30).

Taxation of a Beneficiary. A beneficiary is taxable on:

1) His/her share of the trust's income for the taxable year required to be distributed currently, whether distributed or not, limited in proportion to the beneficiary's share of the "distributable net income" (DNI) of such income, (IRC §662(a)(1), and

2) All other amounts properly paid, credited, or required to be distributed. If the amount required to be distributed currently to all beneficiaries plus all other amounts properly paid, credited or required to be distributed to all beneficiaries, exceeds the DNI of the trust, each beneficiary's taxable amount is limited proportionately. (IRC §662(a)(2)). As indicated above, the

beneficiary may be entitled to a foreign tax credit for foreign tax paid by the trust.

The taxable amounts determined for each beneficiary retain the same character as they had within the trust. (IRC §652(b)).

A gift or bequest which, under the governing instrument is properly paid or credited as a gift or bequest as a specific sum of money or specific property and which is paid or credited all at once, or within not more than 3 installments, is generally not subject to the taxable distribution rules above. (IRC §663)).

Nonresident aliens are only taxable on the portion of a distribution attributable to US source income and income effectively connected with a US trade or business, again limited to their proportion of the trust's current DNI.

If the terms of the trust require that all its income be distributed currently, the beneficiary is generally required to include that income on his/her tax return regardless of whether it is actually distributed. (IRC §652(a)). As stated above the character of the income for the beneficiaries' income tax purposes retains the same character (i.e. interest dividends, etc., as it had in the trust itself. (IRC §652(b)).

Accumulation Distributions.

The concept of an "accumulation distribution" generally does not apply to nongrantor domestic complex trusts. (IRC §665(c)). But see Accumulation Distributions below under ***Nongrantor Foreign Complex Trust***.

Nongrantor Foreign Complex Trust

Many Canadians purchase their US residence though a nongrantor Canadian complex trust.

Taxation of the Trust.

The income of the trust includes the worldwide income of the trust without regard to the effect of tax treaties. (IRC §643(a)(6)(B)). However, a nongrantor foreign complex trust is subject to US tax only on certain US source fixed or determinable income (dividends, etc.) and income "effectively connected" with a US trade or business, including US real estate sales.

The relevant DNI of a foreign trust is generally computed in a similar way to that of a domestic trust. However, unlike domestic trusts, as stated above, capital gains of a nongrantor foreign trust are included in DNI regardless of whether they are included in income under the trust document or local law. (IRC §643(a)(6)(C)). Thus a nongrantor Canadian complex trust is subject to US tax on its US real estate gains. Gain on the sale of a personal use residence held more than one year is generally subject to a maximum US tax of 15% (under current rules).

Taxation of a Beneficiary.

Beneficiaries of a nongrantor foreign complex trust are generally taxed under the same method as a nongrantor domestic complex trust except for two major exceptions.

1) Of course nonresident aliens are only subject to tax on distributions to the extent they are from US source income or income "effectively connected" with a US trade or business, and

2) Special rules apply to an accumulation distribution from a nongrantor foreign complex trust.

The income distributed to a beneficiary generally retains the same character as it had in the trust. (IRC §§652(b), 662(b), Rev-Rul 81-244, and Rev-Rul 86-76). (But see "Accumulation Distributions" below).

The determination of the trust's income as "effectively connected" or "fixed or determinable" is made at the trust level. (IRC §§652(b), 661(b)). A beneficiary's net "effectively connected" income is generally taxed at the usual graduated U.S. income tax rates, except for certain real estate gains as described below.

The beneficiaries of a nongrantor foreign trust receive a credit against their US tax liability for the trust's US taxes (e.g. tax withheld at source on US dividends), and foreign tax payments in the case of a US beneficiary. A US beneficiary must gross up the income to include the amount withheld. (Reg. 1.1441-3(f)).

US Real Estate Sales. Gain on the sale of US real estate is treated as if it is income "effectively connected" with a US trade or business and therefore subject to US tax. If the income from the sale is distributed in the current year, or required to be distributed in the current year, the trust is entitled to a distribution deduction and the beneficiary is required to file a US income tax return to report the income (subject to the DNI limitation). The character of the income in the hands of the beneficiary remains the same as it was in the trust. (IRC §662(b)). Thus income from a real estate gain in the trust is treated as a real estate gain when distributed to the beneficiary.

Regulations provide that real property interests held by a nongrantor trust are deemed held by the beneficiaries. (Reg. §1. 897-1(e)(3)). Thus real estate gains recognized by a nongrantor foreign trust are taxed as U.S. source "effectively connected" income to its beneficiaries.

Accumulation Distributions.

A set of potentially negative tax rules may apply in the case of receipt of an "accumulation distribution" from a nongrantor foreign complex trust. In this case there is a "throwback rule". (IRC §665, §666, §667 and §668). The rules for accumulation distributions do not apply to nongrantor domestic complex trusts. (IRC §665(c)).

In addition, the "character rule" does not apply to US citizens and residents, and therefore any accumulation distribution of capital gain is taxed as ordinary income to a US beneficiary. The character is retained however, in the case of nonresident aliens and foreign corporations. (IRC §667(e)).

The source rules still apply. Therefore the distribution of gain from the sale of US real estate is still US source income even if it is distributed to the beneficiaries many years after the actual sale of the real estate. Thus the nonresident alien may be subject to US tax in the year the gain from the real estate sale is distributed.

A nongrantor foreign complex trust makes an "accumulation distribution" in any year in which the trust distributes more than its current DNI, if it has "undistributed net income" (UNI).

An "accumulation distribution" (IRC §665(b)) means, for any taxable year of the trust, the amount by which:

1) Any other amounts properly paid or credited or required to be distributed in a taxable year, exceed

2) The DNI for such year reduced (but not below zero) by any amount of income for the year required to be distributed currently. (i.e. IRC §661)(a)(2) minus IRC §661(a)(1)).

Undistributed Net Income. (UNI) - a trust has UNI for any year in which the trust's DNI for the year exceeds:

1) The trust's distributions for that year, (the amounts specified under IRC §661(a)(1) and (2), and

2) The federal income tax imposed on the trust that year. (IRC §665(a)).

These rules may result in certain US tax consequences for Canadians using a Canadian irrevocable trust to purchase their US residence. When the trust itself sells the US residence, the trust (under current rules) may only be subject to 15% US tax on the profit, assuming the residence was held for more than one year. As described above, if the profit is distributed to the beneficiary in that tax year, generally there will not be any tax to the trust on the sale, and a Canadian beneficiary that is a nonresident alien of the US will be subject to the tax on the distributed profit on the sale at the 15% tax rate (under current rules).

Throwback Rule. The accumulation distribution is also subject to the "throwback rule".

The throwback rule determines the beneficiary's tax on the accumulation distribution in 5 steps:

1) The number of preceding taxable years of the trust to which the distribution is attributable is determined. The years to which the distribution is attributable are the earliest years of the trust in which the trust had UNI.

2) The average years are determined. These are the beneficiary's 5 immediately preceding taxable years, ignoring the years with the highest and lowest taxable incomes. These are the "base years".

3) The average annual accumulation is determined by dividing the total accumulation distribution by the number of years in which it was accumulated. The average annual accumulation is added to the beneficiaries' taxable income in each of the three base years.

4) The increase in a beneficiary's tax caused by the addition of the average annual accumulation in each of the three base years is computed and averaged.

5) The "partial tax" on the accumulation distribution is computed by multiplying the average of the annual additional tax (determined under 4) above) by the number

of years of accumulation, and subtracting a credit for the tax paid by the trust on the distribution.

Credit for Taxes Paid by the Trust. The beneficiary of the trust receiving the accumulation distribution receives a credit for tax paid by the trust. But the amount of these taxes must first be added to the accumulation distribution and then credited against the beneficiaries taxes. (IRC §665(d).

The amount of foreign tax attributable to each base year is calculated by dividing the total foreign tax paid in all the years to which the accumulation distribution applies (not just the base years) by the number of years to which the accumulation distributions applies (i.e. not just the base years).

In other words a determination is made of the average tax paid in the years to which the accumulation distribution applies and this average amount is added to the amount treated as a distribution in each base years and is treated as potential foreign tax credit (or deduction) in each base year.

Interest Charge.

In addition to the calculations required above, an accumulation distribution is subject to a nondeductible "interest charge" on the beneficiary's tax on the accumulation distribution for each year of the accumulation distribution.

The interest charge is based on the amount of additional tax imposed on the beneficiary on account of the accumulation distribution. If the accumulation distribution is attributable to more than one year, the period for which interest runs is the "dollar-weighted" average number of years of the accumulation rounded to the nearest half year.

If adequate records are not available to make the proper calculations the amount will be deemed to be an accumulation distribution from the earliest year the trust was in existence. (IRC §666(d)).

REQUIRED YEAR END FOR CANADIAN PRIVATE CORPORATIONS OWNED BY US CITIZENS

If you are a US citizen or resident (including a green card holder living in Canada) and you personally own a private Canadian corporation, the US tax code requires the corporation's tax year, for US tax purposes, generally to end on December 31. You may be able to elect a November 30 year end. (IRC §898).

A December 31 tax year end may conflict with tax planning undertaken in Canada for individual shareholders who are resident in Canada, but it is possible to have a fiscal year in Canada for Canadian tax purposes and a calendar year for US tax reporting purposes. Please also see the article "***YOUR "REQUIRED" TAX YEAR FOR YOUR US TAX RETURN***" in the Fall, 2010, issue of the Taxletter.

INDIVIDUAL STATE FILINGS FOR ESTATE TAX

In addition to US federal estate tax some 15 or so individual States (not including Florida) also levy State estate tax or require a filing of some nature.

Thus the Estates of decedent's who owned property in those States must file a State estate tax return. States that may be most applicable for Canadians include Maine, Massachusetts, New York, Vermont, Washington, and Hawaii. But the rules are constantly changing - please contact your tax advisor.