BRUNTON'S U.S. TaxNotes 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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FALL 2012

Amnesty Programs

Readers are aware the Internal Revenue Service (IRS) initiated the 2012 Offshore Voluntary Disclosure Program ("2012 OVDP") in early 2012 with terms fairly similar to the 2011 OVDI.

In addition, in June, 2012, the IRS announced a new additional "streamlined" amnesty procedure effective September 1, 2012. Taxpayers making a submission under the streamlined procedure are required to file delinquent returns for the past three years and to file delinquent FBAR's (Form TD F90-22.1) for the past six years. In addition, participants must respond to an IRS questionnaire consisting of 20 questions, which is reprinted on pages 11 and 12.

For those taxpayers entering the streamlined program and presenting a "low compliance risk", the IRS review will be expedited and the IRS will not assert non-reporting penalties or pursue follow-up action. Of course any tax due must be paid.

However, submissions that present "higher compliance risk" are not eligible for the streamlined processing and will be subject to a more thorough review. Once a taxpayer makes a submission under the streamlined procedure, participation in the 2012 OVDP is no longer available! Hence it could be very important to correctly evaluate whether you represent a "low compliance risk", before making a submission in the streamlined procedure.

Absent any high risk factors, if the submitted returns and application show less than $1,500 in tax due in each of the years, they will be treated as low risk and processed in a streamlined manner. The risk level may rise if any of the following are present:

1) If any of the returns submitted through this program claim a refund,

2) If there is material economic activity in the United States,

3) If the taxpayer has not declared all of his/her income in his/her country of residence,

4) If the taxpayer is under audit or investigation by the IRS,

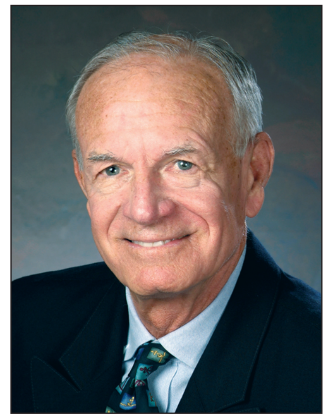
5) If FBAR penalties have been previously assessed against the taxpayer or if the taxpayer has previously received an FBAR warning letter,

6) If the taxpayer has a financial interest or authority over a financial account located outside his/her country of residence,

7) If the taxpayer has a financial interest in an entity or entities located outside his/her country of residence,

8) If there is US source income, or if there are indications of sophisticated tax planning or avoidance.

The IRS questionnaire mentioned above, and set out on pages 11 and 12 must be completed and attached to the request to enter the streamlined program. There are several other terms associated with the streamlined procedure. Please consult your tax advisor. However it appears for many people a primary consideration in their decision to enter the streamlined program is an evaluation of their "risk" status.



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 41 YEARS.

Estate Tax and the Fiscal Cliff

For deaths in calendar year 2012 the tax code provides an estate tax credit equivalent

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to an "exclusion" from estate tax for US citizens and US domiciliaries for the first $5.12 million of assets, provided there were no prior taxable gifts. The tax rate is 35% on the taxable estate in excess of $5.12 million.

If no action is taken by Congress the aggregate "exclusion" for estate and gift tax will be reduced to $1 million on January 1, 2013, and the tax rate will be 55% on the excess.

President Obama has proposed setting the estate tax exclusion at $3.5 million with a 45% tax rate on the excess, and with a gift tax lifetime exclusion portion of $1 million.

FBAR Penalty Levied

A US court upheld an IRS assessment of $100,000 in penalties for each of the years 2000 and 2001 against a US citizen for failure to file FBAR's (Form TD F 90-22.1). (J. McBride, US District Court, Utah, Central Division, November 8, 2012).

Grand Jury Subpoena – Taxpayer Compelled to Produce Foreign Bank Account Records

The US Court of Appeals, Ninth Circuit (11-3799, August 27, 2012) upheld a Grand Jury subpoena requiring an individual to produce foreign bank account records. Under 31 USC §5311 foreign bank records are required to be maintained, and compelling them to be produced does not violate an individual's Fifth Amendment privilege against self-incrimination. Under the "required records doctrine" an individual may be compelled to produce records that:

1) Are required to be kept pursuant to a valid regular regulatory program,

2) Contain customarily kept information, and

3) Assume public aspects that render them an analogous to public documents.

The court held that the Fifth Amendment is not a barrier to the enforcement of a valid civil regulatory scheme.

FATCA Update

Readers are aware in 2010 the U.S. Congress enacted legislation (The Foreign Account Tax Compliance Act – "FATCA") requiring withholding agents to withhold 30% of certain payments to a foreign financial institution (FFI) unless the FFI has entered into an agreement (FFI Agreement) with the IRS to, among other things, report certain information to the IRS with respect to accounts held by US persons. Thus, Canadian banks and brokerage firms etc. will be required to provide to the IRS financial information on their clients who are US citizens, or else suffer the 30% withholding rule.

In November, 2012, the IRS issued Announcement 2012-42, outlining timelines for due diligence and other requirements for the participating FFI's (for example, Canadian banks and Canadian brokerage firms with US citizen clients which have entered into an FFI Agreement with the IRS to avoid the 30% withholding.).

New Account Opening Procedure. Participating FFI's generally will be required to implement new account opening procedures by January 1, 2014.

Pre-Existing High-Value Accounts. A participating FFI must perform the requisite identification procedures on their clients and obtain the appropriate documentation to identify pre-existing US individual accounts that are high-value accounts by the later of December 2014, or the date which is one year after the effective date of the FFI Agreement.

Pre-Existing Accounts Other Than High-Value Accounts. A participating FFI must perform the requisite identification procedures on their clients and obtain the appropriate documentation to identify pre-existing US individual accounts (other than high-value accounts) prior to the later of December 31, 2015, or the date which is two years after the effective date of the FFI Agreement.

First Reporting of US Accounts. A participating FFI will be required to file information reports to the IRS on its US clients with respect to the 2013 and 2014 calendar years not later than March 31, 2015.

As mentioned in the Summer, 2012 "*US Tax Notes for Canadians*" the IRS has provided for the use of an Intergovernmental Agreement (IGA) instead of an FFI Agreement whereby the foreign government (for example, Canada) can provide the information to the IRS rather than having the FFI provide the information directly to the IRS. The US Treasury has released a second Model Intergovernmental Agreement to assist countries in negotiating IGAs with the US. The agreement includes an annex (Annex I) detailing the due diligence obligations of the FFI for identifying and reporting on US accounts and on payments to certain nonparticipating FFI's.

Mexico, the UK and Denmark have already entered into IGAs with the US.

IRS Issues Inflation Adjustments for 2013

In Revenue Procedure 2012-41 the IRS issued some inflation adjustment amounts for 2013. Some of the relevant ones for readers are:

Foreign earned income exclusion	$97,600
Annual gift tax exclusion (generally)	$14,000
Annual gift tax exclusion for gifts to a nonresident alien spouse	$143,000
Expatriation to avoid tax “Average annual net income tax”	$155,000
“Exemption”	$668,000

Nonresident Can Use Losses Incurred While a Resident

In private letter ruling (PLR) 201228013 the IRS determined that an individual who incurred net operating losses (NOLs) while he was a resident alien of the United States, could use those NOLs as a deduction against income on a US tax return after he became a nonresident alien of the United States. The IRS ruled that he could do so to the extent the NOLs were allocable and/or apportionable to gross income effectively connected with a US trade or business.

California Nexus for Sales Tax

Readers are aware various States require the collection and payment of sales (or “use”) tax if the seller has "nexus" (for sales tax purposes) in that particular State and the purchaser or the product are not exempt from the sales or use tax requirement.

The definition of “nexus” can be extended to the definition of "affiliate nexus" in some cases. California has advised that under its "affiliate nexus provision", a retailer is engaged in business in California and required to register to collect California use tax if the retailer enters into an agreement or agreements under which a person or persons in California, for a commission or other consideration, directly or indirectly refers potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet website, *or otherwise*, provided that the retailer’s sales exceed two specific sales thresholds.

Georgia Sales Tax

New law went into effect October 1, 2012, in Georgia under which out-of-state sellers are required to collect sales tax from Georgia customers if:

1) A person or entity located in Georgia, on the seller's behalf, delivers, installs, or assembles the seller's product, or performs maintenance services, provides a customer pick-up service in Georgia, or performs other similar activities in Georgia on the seller's behalf, or

2) A related company located in Georgia sells similar products using a similar business name as the out-of-state seller, or

3) If the related company uses trademarks, service marks or trade names in Georgia similar to those that the seller uses.

Georgia has also implemented a "click-through’ nexus law for sales tax, similar to the “click-through” laws we previously described.

US Residents Claiming Canadian Withholding Benefits

Prior Taxletters letters mentioned various IRS forms to be used by nonresident aliens of the US who are resident in Canada to claim reductions in US withholding tax based on tax treaty or other provisions. Of course Canada also has procedures to assist US residents in obtaining relief from Canadian withholding tax.

Canada Revenue Agency (CRA) Form NR301 can be used by a US resident to reduce Canadian withholding tax applicable to dividends, pensions, annuities, royalties, and estate or trust income. That form can also be used when completing CRA Form T2062 to request a certificate of compliance for the disposition of treaty protected property.

CRA Form NR302 can be used to claim eligibility for benefits under the tax treaty for a partnership with US partners.

CRA Form NR303 is used to claim eligibility for benefits under the tax treaty for a hybrid entity involving US persons.

Taxpayer Allowed to Make Late PFIC Election

The US tax consequences for a US citizen or US resident investing in a non-US mutual fund can be disadvantageous if the mutual fund is classified as a "PFIC". Please see the article ***"BEWARE - PFICS CAN BE DANGEROUS!"***

One potential way to improve the tax result is to make the "mark to market" election to pay tax annually on the appreciation. The election generally must be made by the deadline. However the IRS recently allowed a taxpayer to make a late election, under the authority of regulations that provide the IRS with discretion to grant a taxpayer a reasonable extension of time in certain cases. (Private letter ruling 201244003). Please see the article ***"IRS CAN GRANT EXTENSIONS FOR ELECTIONS"***.

Separately, the IRS has been commonly approving requests for extensions to elect income deferral for RRSPs and RRIFs under Article XVIII of the tax treaty.

Interest Deductions by Canadian Corporations

Canadian corporations filing US income tax returns can deduct a portion of their interest expense in certain cases even if there is no interest expense paid by the US branch. We described the methodology to calculate the interest expense in prior newsletters. A strict reading of the tax regulations suggests such a deduction can only be taken if the corporation has debt denominated in US dollars, in which case the interest rate to use for the US deduction will be determined from the interest rate on that debt. However the IRS issued an Office of Chief Counsel Memorandum (AM 2009-015) indicating that a foreign corporation not having US-dollar denominated liabilities should use an interest rate that is "reasonable under the facts and circumstances".

Same-Sex Spouse Entitled to Marital Deduction

The United States Court of Appeals has affirmed a New York Court decision entitling an estate to an estate tax marital deduction for a same-sex spouse. (E. Windsor CA-2, October 19, 2012).

LATE FILING PENALTY & "REASONABLE CAUSE"

The avalanche of legislation in recent years imposing penalties for the failure to timely file US reporting forms such as IRS Form 3520, and the FBAR (Form TD F 90-22.1) has highlighted the importance of the procedure to obtain relief from IRS penalties.

The penalty for late filing of tax returns (generally 5% of the tax due, subject to a maximum) can be waived by the IRS if the taxpayer can show that the failure to timely file did not result from *willful neglect* and that the failure was due to "*reasonable cause*".

Similarly, the $10,000 penalty for late filing of reporting forms such as IRS Forms 3520 and 5471 may be waived by the IRS if the taxpayer can demonstrate "reasonable cause".

Willful neglect is defined as a conscious, intentional failure, or reckless indifference. (US v. Boyle 469 US 241).

Reasonable cause may exist if the taxpayer can demonstrate he/she exercised ordinary business care and prudence in determining tax obligations, but nevertheless was unable to comply with those obligations. See Internal Revenue Manual (IRM) 20.1.1.3.2 (5)).

To claim reasonable cause in connection with late filing the taxpayer must provide a written statement to the IRS made under penalties of perjury. (Reg. §301.6651-1(c)(1)). Some of the factors that the IRS considers in determining reasonable cause are (IRM 20.1.1.3.1):

1) What happened and when did it happen,

2) During the period of time the taxpayer was noncompliant, what facts and circumstances prevented the taxpayer from filing a return,

3) How did the facts and circumstances prevent the taxpayer from complying with the law,

4) How did the taxpayer handle the remainder of his/her affairs during this time, and

5) Once the facts and circumstances changed, what attempt did the taxpayer make to comply.

Apparently a taxpayer may reasonably rely on an expert's advice. Thus, if an expert incorrectly advises the taxpayer that no return is required, or incorrectly advises the taxpayer that it can be filed beyond the due date, reasonable cause may be found. (See Estate of La Meres v. Commissioner 98 TC 294, 316-317 (1992)).

Obtaining relief from late filing penalties requires a demonstration not only of reasonable cause, but also that the taxpayer acted in good faith, or that there was an absence of willful neglect. On the other hand, some other penalties require only a demonstration of "reasonable cause" for relief.

FORM 8938 AND PENSIONS

US citizens and US residents must report their foreign deferred compensation plans and foreign pension plans on IRS Form 8938, assuming the Form 8938 filing threshold is met. (See FAQ #12 on the IRS's "Basic Questions and Answers on Form 8938" on the IRS website). For purposes of the amount to be used in determining whether the filing threshold is reached, the value of your interest in the plan is the fair market value of your beneficial interest in the plan on the last day of the year. (FAQ #13).

If you do not know or have reason to know, based on readily assessable information, the fair market value of your beneficial interest in the plan on the last day of the year, the maximum value is the value of the cash and/or other property distributed to you during the year. (FAQ #13).

If you do not know or have reason to know, based on readily assessable information, the fair market value of your beneficial interest in the plan on the last day of the year, and did not receive any distributions from the plan, the value of your interest in the plan is zero. In this situation you use the value of zero for the plan in determining whether you have met the filing threshold. In this case if you have otherwise met the filing threshold and are required to file Form 8938, you report the plan and indicate the maximum value was zero. (FAQ #13). Question: Given the potential $10,000 penalty for noncompliance, is it risky to assume a value of zero if, with a minimal amount of effort, (e.g. a letter to the plan administrator) you could obtain an approximation of the value of your interest in the plan?

Are you required to report your interest in the amounts you contributed to the Canada/Québec pension plan, even if you are not yet receiving distributions? The IRS says it is unnecessary – see FAQ #14.

CANADIANS OWNING PARTNERSHIPS WHICH INVEST IN THE US

Many nonresident aliens of the United States who are resident in Canada, and Canadian corporations, invest in partnerships with US activities (for example real estate partnerships). If that Canadian individual or corporation has another business activity in the US, the other business activity may not have full treaty protection.

For example, suppose the Canadian is a limited partner in a partnership that invests in US real estate and the Canadian also has a Canadian business with sales in the United States but no employees or office in the United States. Normally, the Canadian might consider he/she is not engaged in business in the United States and/or does not have a "permanent establishment" in the United States, and is therefore not subject to US tax on the business sales in the United States. However, that conclusion may often be incorrect.

Under US tax law ***if*** a nonresident alien or non-US corporation is engaged in business in the United States ***then all*** its income from the United States (other than so-called "FDAPI") is treated as "income effectively connected with the US trade or business". (IRC §864(c)(3)). ("FDAPI" is fixed or determinable, annual or periodic income that is not connected with US business such as dividends, pensions, annuities, etc.).

Unfortunately, if a partnership in which the Canadian has invested, is considered engaged in a US trade or business (which will likely be the case for most partnerships with significant US activity) then each partner is also considered to be engaged in a US trade or business! (IRC §875(1)). The fact that you are a limited partner will not prevent imputation of the partnership's trade or business status to you. (Regs. §1.875-1)).

Thus if you invest in a partnership which invests in US rental real estate, for example, it is possible you will be considered engaged in a US trade or business with respect to other business revenue you have from US sources. This other business revenue will therefore be subject to US income tax unless you do not have a "permanent establishment" in the United States.

Do you have a "permanent establishment" ("PE") in the United States? Routinely, if the other business revenue is derived, for example, solely from sales to United States customers that are made in, and shipped from, Canada and you do not have any employees or office in the United States, you might conclude you do not have a PE in the US. Unfortunately, however, if the partnership has a US PE, the IRS takes the position that the rule of Section 875 that attributes trade or business status to you also attributes the partnership's PE to you! (Rev-Rul 90-80). The IRS position was upheld in two cases involving Canadians. (Donroy v. US 301 F2nd 200 and Unger v. Comr. TC Memo 1990-15).

Thus, if you have an otherwise treaty-protected US business, that treaty protection might be jeopardized if you have a separate interest in a partnership with US activities.

CFCS AND EARNINGS & PROFITS

Readers are aware US citizens and residents who own "controlled foreign corporations" (CFCs) whose income is predominantly passive (e.g. interest, dividends capital gains etc.) may be required to include the corporation's income on their personal US income tax return, even if the income is not distributed to them. (The inclusion of so-called Subpart F income).

However there is an important potential limiting factor in determining the maximum amount that must be included in income. In general, the amount to be included in income of the shareholder cannot exceed the "earnings and profits" of the corporation for that tax year (i.e. the "current E&P"). (IRC 952(c)(1)(A). Thus the definition of E&P becomes important.

Unfortunately there is no all-inclusive definition of E&P. Accumulated E&P must be distinguished from the financial accounting concept known as "earned surplus" or "retained earnings". Similarly current E&P is distinguishable from "taxable income". Internal Revenue Code Section 312(n) sets out some differences between the two. See also Regs. §1.312-6.

E&P may be more of an economic concept than an accounting concept. However taxable income can be a starting point for determining current E&P. The Code, regulations, and cases indicate that the following are some of the differences between taxable income and E&P:

1) E&P appears not to be reduced for such items as stock dividends, quasi-reorganizations, and reserves for contingencies.

2) E&P includes interest from tax-free state and local debt instruments.

3) A cash basis corporation may be allowed to accrue federal income tax.

4) Generally, if a corporation uses LIFO inventories, the installment sale method, the completed contract method of accounting, or accelerated depreciation, it must recalculate its earnings for E&P purposes. (IRC §312 (n)(4) through (6)).

5) Some nondeductible expenses including penalties may generally reduce E&P.

The limitation mentioned in Section 952(c)(1)(A) above has the effect of allowing current Subpart F income to be offset by current non-Subpart F losses. (But non-tax Subpart F income of the CFC will be re-characterized as Subpart F income to the extent that prior deficits in E&P attributable to non-Subpart F income, were used to reduce prior Subpart F income. (IRC §952(c)(2)).

Generally, for years beginning after 1986, prior deficits in E&P can reduce the amount to be included in income provided the loss was from the same "activity". (IRC §952(c)(1) (B)).

Although distributions during the year reduce accumulated E&P, they do not reduce the current E&P limitation for purposes of calculating Subpart F income (Regs. §1.952-1(c) (1)), nor do they reduce current E&P for purposes of "dividend" computations.

CROSS-BORDER TRANSFER PRICING & CONTROLLED SERVICES

Canada and the US have "transfer pricing" rules to prevent taxpayers from shifting taxable profit between countries. Some US rules are located in regulations under Section 482. Among other transactions addressed in the regulations, are transactions involving a "controlled service"- a service between controlled parties.

The regulations (§1.482-9(a)) provide various different methods that can be used to set prices in a controlled services transaction. The regulations provide a potential "safe harbor" for one method, referred to as the

"Services Cost Method" (SCM). Under the SCM if a taxpayer meets the requirements for SCM it may charge for controlled services at cost.

"The services cost method evaluates whether the amount charged for certain services is arm's length by reference to the total services costs, with no markup". (Regs. §1.482-9(b) 1)).

Eligibility

To apply the SCM all the following requirements must be met:

i) the service a "covered service",
ii) the service is not an "excluded activity",
iii) the service is not precluded from constituting a covered service by the "business judgment rule", and
iv) adequate books and records are maintained as required in the regulations.

A "covered service" is:

a) a service that is designated as such in IRS Revenue Procedures, and also
b) a "low-margin covered service" meaning a transaction for which the median comparable markup on the total services costs is this less than or equal to 7%. (See Regs. §1.482 9(b)(3)(ii)).

"Excluded activities" are; manufacturing; production; extraction, exploration, or processing of natural resources; construction; research, development, or experimentation; engineering or scientific; financial transactions; and insurance or reinsurance.

Under the "business judgment rule" a service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more of the trades or businesses of the control group. (Regs. §1.482-9(b)(5))

The rules are extremely detailed and complex. Please consult your tax advisor before taking any action.

BEWARE - PFICS CAN BE DANGEROUS!

Readers are aware a US Citizen or US resident (including a green card holder living in Canada) has potentially significant US tax disadvantages when owning a PFIC. A PFIC (a Passive Foreign Investment Company, under the US tax code), can in many circumstances include a Canadian mutual fund, and potentially a Canadian REIT or Canadian Income Trust, or perhaps even some Canadian exchange traded funds (ETFs).

Very Simplified Example

In year 1 Sam (a US citizen living in Canada) purchases directly a Canadian mutual fund for $1,000 that constitutes a PFIC under US tax rules. On December 31st in year 11 Sam sells the mutual fund for $11,000.

Sam may assume that for US income tax purposes he has a $10,000 long-term capital gain in year 11 taxable at a maximum tax rate of 15%. Thus the tax could be $1,500 - which may be reduced or eliminated to the extent that it is offset in the US by Canadian tax.

However if the mutual fund constitutes a PFIC the $10,000 profit is instead "spread back" for US tax purposes over the 10 years during which Sam owned the mutual fund. In other words $1,000 of profit is allocated to year 2, $1,000 is allocated to year 3 and so on. Sam is then taxed in each year, (year 2, year 3, etc.) at the maximum US income tax rate in effect for that particular year. (For year 11 he is taxed at his marginal rate). In recent years the maximum US federal tax rate has been 35%. Thus the tax could be about $3,500 on $10,000 of profit.

But there is more. The IRS levies an interest charge on Sam because he did not pay in year 3 the 35% US tax attributable to year 2's profit allocation, he did not pay in year 4 the 35% tax year attributable to years 3's profit allocation etc., through the full 10 years. The interest is compounded daily from the day the tax liability is deemed to be attributed.

Thus, in Sam's case the US tax and interest could be $4,000-$5,000 or higher on the $10,000 profit.

This is a very simplified example. Please contact your tax advisor before taking any action.

Do you have a PFIC?

Superficially the determination of whether your Canadian corporation, or one of your investments (mutual fund or otherwise) is a PFIC is straightforward. However in practice there are many surprises and many exceptions.

In general a foreign corporation is a PFIC if it meets 1 of 2 tests:

1) The gross income test, or

2) The average percentage of assets test.

As mentioned in prior newsletters the IRS has determined that a foreign trust might be treated as a foreign corporation (and thus potentially a PFIC) if the trustees have certain "powers to vary" the investments.

The Gross Income Test. The corporation meets the gross income test if 75% or more of its gross income is passive income as defined in IRC §954(c) – i.e. "foreign personal holding company income", as set out in the rules for "controlled foreign corporations" (CFCs). (IRC §1297(a)(1)). Thus, among other types of income, passive income includes dividends, interest, royalties, annuities, certain capital gains, personal service contract income, and certain rental income.

Various exceptions apply, including rents and royalties received from unrelated persons, that are derived in the active conduct of a trade or business are not included as passive income. For example please see Regs. 1.954-2(b)(5).

According to PLR 94467016 it is possible that a foreign corporation engaged in active business could still qualify as a PFIC under the gross income test if it has a net operating loss in any given year from its business operations and also has passive income from investments that exceeds the loss.

The Average Percentage of Assets Test. The corporation meets this test if the average percentage of assets held by the corporation during the taxable year which produce passive income or which are held for their production of passive income is at least 50% of total assets). (IRC §1297(a)(2)). For purposes of the Assets Test, Code Section 1297(e) describes how you "measure/value assets". Measuring/valuing assets can be very complex. Apart from Section 1297(c), IRS Notices 88-22 and 89-81 may provide some assistance. The asset test is applied on a gross basis (IRC §1297(e)). No liabilities are taken into account, even those secured by assets.

Very simplistically:

1) If the corporation is a publicly traded corporation the asset test is applied based on the value of the assets. (IRC §1297(e)(1)(A)).

2) If the corporation is not a publicly traded corporation, and it is a controlled foreign corporation (CFC) or if it elects the provisions of Section §1297(e)(2) the asset test will be applied on the adjusted basis of its assets. (IRC §1297(e)(2)).

3) If neither 1) nor 2) above applies, the asset test will be applied on the basis of the value of assets. (IRC §1297(e)(1)B)).

As a result, a nonpublicly traded non-CFC has a choice of using the adjusted basis method or fair market value method. An election must be made to use the adjusted basis method. (IRC 1297(e)((2)(B)).

Special computations may be required in cases where the corporation owns an interest in a partnership or shareholder attribution rules apply.

THE NATURE OF IRS REGULATIONS

The IRS issues two types of regulations:

1) Legislative regulations, and

2) Interpretive regulations.

Legislative regulations are issued under the specific authority of the particular Internal Revenue Code Section applicable. In this case, the wording in the particular Code Section involved states that "The Secretary" (the Department of the Treasury/IRS) is authorized to issue regulations providing guidelines as to how the Code Section is to operate. For example see Code Section 6039F(e).

Regulations that are not legislative regulations are referred to as interpretive regulations and they are issued under the authority of Code Section 7805.

Until recently, it was generally considered that legislative regulations were more authoritative than interpretive regulations. However in a recent court case (Mayo Foundation v. US, 131 S. St. 704 (2011)), the court determined that deference should be given to regulations under a two-step process.

1) Under the first step, the court must determine whether the intent of Congress was clear from the Code Section itself. If it is clear, then the Code Section governs, regardless of any regulation. On the other hand, if the Code Section is ambiguous or silent on the specific issue involved, then

2) The court must determine whether the regulation is based on a permissible construction of the statute (i.e. the Code). If it is a permissible construction, the court must give

deference to the regulation regardless of whether it is a legislative or interpretive regulation.

IRS CAN GRANT EXTENSIONS FOR ELECTIONS

Many unfortunate US tax results can stem from a failure to make timely elections. Thus it is important to know the options in the event of failure to make a timely election.

Since the rules for the timing of many elections are determined on the basis of IRS regulations, the IRS has issued Reg. §301. 9100-1(a) which states the IRS will use Regs. § 301.9100-2 and 301.9100-3 to provide the standards to determine whether it will grant an extension of time to make a regulatory election.

Regulation §301.9100-2 Automatic Extensions

Automatic 12 Month Extension. Reg. §301.9100-2(a) sets out nine election circumstances eligible for an automatic 12 month extension. Although they should be reviewed, it appears few would be commonly used in the cross-border context.

Automatic 6 Month Extension. Under Reg. 301.9100-2(b) an automatic extension of 6 months from the due date of a return, excluding extensions, is granted to make a regulatory or statutory election whose due dates are the due date of the return or the due date of the return including extensions, provided the taxpayer timely filed its tax return for the year the election should have been made, and the taxpayer takes "corrective action" within that 6-month extension period. This automatic extension does not apply to regulatory or statutory elections that must be made by the due date of the return excluding extensions.

For elections required to be filed with the return "corrective action" includes filing an original or an amended return for the year the regulatory or statutory election should have been made and attaching the appropriate form or statement for making the election. (See Regs. §301.9100-2(c)).

Any return, statement of election, or other form of filing which must be made to obtain an automatic 6-month extension must provide the following statement at the top of the document: "FILED PURSUANT TO SECTION 301.9100-2". No request for a letter ruling is required, and use fees do not apply to taxpayers taking corrective action.

Regulation §301.9100-3 Other Extensions

Requests for extensions of time for regulatory elections that do not meet the requirements of section 301.9100-2 must be made under the rules of Regs. §301.9100-3. *"Requests for relief subject to the section will be granted when the taxpayer provides the evidence (including affidavits described below) to establish to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government"*

"Reasonably and in Good Faith". The taxpayer is deemed to have acted "reasonably and in good faith" if the taxpayer –

i) requests relief before the failure to make the regulatory election is discovered by the IRS,

ii) failed to make the election because of intervening events beyond the taxpayer's control,

iii) failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election,

iv) reasonably relied on the written advice of the Internal Revenue Service, or

v) reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

The taxpayer will not be considered to have reasonably relied on a tax professional if the taxpayer knew or should have known that the tax professional was not competent to render advice on the regulatory election, or aware of all the relevant facts.

The taxpayer is deemed to have not acted "reasonably and in good faith" if the taxpayer –

i) seeks to alter a return position for which an accuracy related penalty has been or could be imposed and the new position requires or permits a regulatory election for which relief is requested,

ii) was informed in all material respects of the required election and related tax consequences, but chose not to file the election, or

iii) uses hindsight in requesting relief. If specific facts have changed since the due date for making the election that make the election advantageous to the taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

"Will Not Prejudice the Interests of the Government". The IRS will use the following standards to determine whether the interests of the government are prejudiced:

i) the interests of the government are prejudiced if granting relief would result in the taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election,

ii) the interest of the government are ordinarily prejudiced if the taxable year in which the regulatory election should have been made is closed by the period of limitations,

iii) the interests of the government may be prejudiced for certain accounting method regulatory elections (See Regs. §301.9100-3(c)(2) and §301.9100-3(c)(3)).

Affidavits. The taxpayer, or the individual who acts on behalf of the taxpayer, must submit a detailed affidavit describing the events that led to the failure to make a valid regulatory election and to the discovery of the failure. For further information on affidavits please see Regs. §301.9100-3(d)(1).

The request for extension for a regulatory election must also state whether any relevant years are being examined by the IRS or the courts. Other documents required are listed in Regs. §301.9100-3(e)(4). Requests are commonly made and commonly granted to make late RRSP/RRIF elections under Article XVIII (7) of the tax treaty.

NEW IRS FORMS TO AVOID WITHHOLDING

In preparation for FATCA (see "**UPDATE ON FATCA!**" above), on May 31st the IRS issued a draft version of a revised Form W-8BEN and a draft version of entirely new IRS Form W-8BEN-E.

Form W-8BEN

Readers are aware IRS Form W-8BEN is a form that has long been used by Canadian individuals and Canadian entities to avoid or reduce US tax withholding on US source income.

For example for Canadian individuals and entities that are not engaged in US business Form W-8BEN is used to avoid US withholding on US interest payments, to reduce the US withholding on US dividends, and to avoid US withholding on certain payments of income from US customers to Canadian businesses.

The main change to the draft revised Form W-8BEN is to limit the use of Form W-8BEN to individuals only. At present, Form W-8BEN applies to both individuals and entities. New form W-8BEN-E will apply only to entities and not to individuals.

Form W-8BEN-E

As indicated, the main difference in the changes is to create a new form W-8BEN-E which applies to entities only. However this version of Form W-8BEN has been expanded from one page to six pages.

Among other purposes, this new Form will be used by Canadian entities to avoid US tax withholding in cases where an entity that is not engaged in US business receives payments from US customers. (In cases where the Canadian entity ***is*** engaged in US business, IRS Form W-8ECI usually is used to avoid US withholding).

Fortunately, the bulk of the six pages of draft Form W-8BEN-E stem from compliance requirements of the so-called "FATCA" legislation, and hence those sections will not be relevant for Canadian entities that are not certain banks or certain other financial institutions.

Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer Taxpayers Questionnaire			
NAME			
ADDRESS			
TIN			
TAX YEARS	YEAR:	YEAR:	YEAR:
Please respond to the following questions by checking YES or NO or providing the requested information.			

ELIGIBILTY	**YES**	**NO**
1. Have you resided in the U.S. for any period of time since January 1, 2009?		
2. Have you filed a U.S. tax return for tax year 2009 or later?		
3. Do you owe more than $1,500 in U.S. tax on any of the tax returns you are submitting through this program?		
4. If you are submitting an amended return (Form 1040X) solely for the purpose of requesting a retroactive deferral of income on Form 8891, are there any adjustments reported on the amended return to income, deductions, credits or tax?		
If you answered yes to questions 1, 2 (except for taxpayers submitting amended returns solely for the purpose of requesting a retroactive deferral of income on Form 8891), 3, or 4, any returns submitted through this program will not be eligible for the streamlined processing procedures and will be treated as high risk returns subject to an examination. If your answer is yes to any of these questions, you may want to consider a submission through the Offshore Voluntary Disclosure Program.		
FINANCIAL ACCOUNTS/ENTITIES		
5. Since January 1, 2006, have you had a financial interest in or signature or other authority over any financial accounts located outside your country of residence?		
a. If yes, are the accounts held in your name?		
b. If yes, list the countries where the accounts were/are held.		
6. Since January 1, 2006, did you have a financial interest in any entities located outside your country of residence?		
a. If yes, do these entities control U.S. investments?		
b. If yes, list the countries where the entities were/are located.		
7. Do you have a retirement account located in your country of residence?		

a. If yes, are earnings from the retirement account non-taxable in the U.S. under current treaty provisions?		
b. If yes, is the retirement account located in Canada and are you filing a delinquent Form 8891 for each year?		
TAX ADVISORS		
8. Did you rely on the advice of a tax professional for not filing required U.S. tax returns?		
a. If yes, is your tax advisor located in the U.S.?		
9. During the above-listed tax years for this submission did you know that you were a U.S. citizen or resident alien?		
a. If yes, did you disclose to your tax professional that you were a U.S. citizen or resident alien?		
10. During the above-listed tax years for this submission, have you declared all of your income in your country of residence?		
11. If you used a tax professional, did you disclose the existence of the accounts/entities you hold outside your country of residence to your tax professional?		
12. Did you know you had a Report of Foreign Bank and Financial Accounts (FBAR), Form TD F 90-22.1, filing requirement when you failed to file an FBAR?		
TAX POSITION		
13. Have you ever filed a U.S. tax return?		
14. Are you currently under audit or investigation by the IRS?		
15. Have you ever filed an FBAR?		
16. Have you received an FBAR warning letter for any of the above-listed tax years for failing to file an FBAR?		
17. Do you have a treaty-based position for your country of residence that reduces your U.S. tax liability?		
18. Were you employed by a U.S. company or entity during any of the above-listed tax years?		
19. During any of the above-listed tax years, did you receive income from any of the following income sources in your country of residence: rental income, sales of property, inheritance?		
20. Are you claiming a refund on any of the returns you are submitting through this program?		
Under penalties of perjury, I declare that I have examined the facts stated in this Questionnaire and to the best of my knowledge and belief, they are true, correct and complete.		
Taxpayer(s) Signature(s)	**Date**	