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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ADMINISTRATIVE/LEGISLATIVE/ JUDICIAL UPDATE

Update on the IRS OVDI and OVDP "Amnesty" Programs

The IRS will be issuing (or will have issued, by the time you receive this) relaxed rules under the FBAR and tax reporting amnesty programs for certain US citizens and US residents. According to an IRS announcement on June 26th (IR-2012-65) these people generally will have simple tax returns and owe $1,500 or less in tax for the covered years.

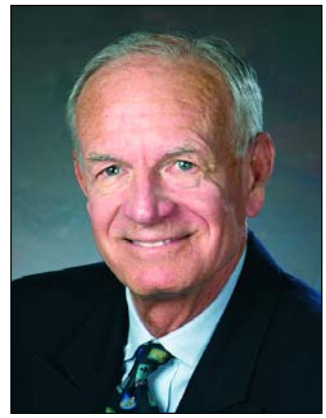
"*Taxpayers using the new procedures will be required to file delinquent tax returns along with appropriate related information returns for the past three years, and to file delinquent FBARs for the past six years. Submissions from taxpayers that present higher compliance risk will be subject to a more thorough review potentially subject to an audit, which could cover more than three tax years*".

The IRS also announced that the new procedures will relax the rules related to certain foreign retirement plans, such as Canadian RRSPs, including late treaty elections. (See OVDI FAQ #54).

ITIN Applications

On June 22nd the IRS announced in IR-2012-62 that, effective immediately, it would no longer accept ITIN (US Individual Taxpayer Identification Number) applications attached to income tax returns when the attached documentation is certified by any person or entity other than the issuing agency.

For example, unlike the system in effect prior to June 22, under which copies of Canadian passports certified by United States notaries or acceptance agents were acceptable, the copies of passports must now be certified by the issuing agency (Passport Canada in the case of Canadian passports).



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Alternatively, the individual can send their original documents (Canadian passport, birth certificate, etc.) to the IRS with the tax return. Of course few will want to do that. Original passports, birth certificates, etc. taken to IRS walk-in sites will be forwarded to the ITIN centralized site for processing. An exception applies for certain military spouses and dependents.

This is an "interim measure" and the IRS says "final rules" will be issued before the start of the 2013 filing season.

The new rules apply to applications attached to income tax returns. The prior rules continue to apply for certain non-tax return purposes such as:

1) Applying for ITINs for the purpose of nonresident aliens claiming tax treaty benefits (the IRS says "use boxes a and h on Form W-7"),

2) Applying for ITINs by nonresident aliens who may be subject to third-party withholding for various income, such as real estate rental income, certain "effectively connected" business income, certain gaming winnings, or pension income, and

3) Applying for ITINs for information reporting purposes - the IRS has not yet given

any examples of this but perhaps it refers to filing Forms 8288, 8288-A, and 8288-B in connection with the sale of US real estate.

Characterizing Cloud Computing Income

Is income derived in "cloud computing" to be characterized as rental income or service income?

A main source of guidance is Reg. §1.861-18. According to a speech at the May, 2012, meeting of the American Bar Association, Section of Taxation, an attorney from the IRS indicated it is likely that a transferor of property would be required to characterize the transaction as a lease, but admitted that the area needs more study by the IRS.

Cloud Computing and Pennsylvania Sales Tax

Pennsylvania has ruled that the use of an out-of-State taxpayer's canned computer software accessed electronically by the user/customer is subject to Pennsylvania sales and use tax if the user/customer is located in Pennsylvania. Because computer software is tangible personal property, a charge for electronically accessing software is taxable. Thus an out-of-state taxpayer is required to collect tax from a customer when the user is located in Pennsylvania.

Charges for remote software access are not subject to sales tax in Pennsylvania if the user is located outside Pennsylvania, even if the server that hosts the software is located in Pennsylvania. (Legal letter ruling No. SUT-12-001, Pennsylvania Department of Revenue, May 31, 2012).

Cloud Computing and Massachusetts Sales Tax

The Massachusetts Department of Revenue has determined that the charges for cloud computing products sold by a taxpayer are not subject to Massachusetts sales tax when the products are used with the customer's own software, or open-source software available for free on the Internet, because there is no sale of prewritten software. A different rule applies for certain cloud computing products that include software licensed by the taxpayer. The rules may be complex - see Massachusetts Department of Revenue, Letter Ruling 12-8, July 16, 2012.

Licensing Agreement Did Not Create Nexus in West Virginia

A West Virginia Court held that an out-of-state corporation which earned royalties from nationwide licensing of food industry trademarks did not have "nexus" in West Virginia, despite receiving royalties from licensees it had in West Virginia.

Its contacts with West Virginia were not sufficient to establish nexus since it had no physical presence in West Virginia and did not sell or distribute food-related products or provide services in West Virginia. (Griffith v. West Virginia state tax commissioner, West Virginia Supreme Court of Appeals, No. 11-0252, May 24, 2012).

Expatriation Legislation

On May 17, 2012, legislation was introduced into committee in the US Senate (S. 3205) which, among other purposes, provides that certain persons renouncing US citizenship for a substantial tax avoidance purpose would be barred from entering the United States.

Portability of Deceased Spouse's Unused Exclusion Amount

We previously summarized the provision in recent estate tax law which provides for portability of any estate tax exclusion amount which is not utilized by the estate of the "decedent". Generally, the unused amount is available for the estate of the "surviving spouse".

However the unused amount is only available to the estate of the "surviving spouse" if an estate tax return for the "decedent" is filed by the due date for filing the "decedent's" estate tax return, and the appropriate portability election is made on the "decedent's" return. On June 18th the IRS issued temporary regulations describing the election.

This deadline for making the portability election may be extremely important to many US citizens living in Canada.

Example: Stephen, a US citizen living in Canada, dies but his worldwide assets are less than the US estate tax filing threshold and therefore his estate does not file a US estate tax return. Subsequently his spouse Marilyn, a US citizen, who inherited all his assets, but who subsequently received a substantial inheritance from other sources, dies and her worldwide assets are above the US estate tax return filing threshold.

If an estate tax return for Stephen was not timely filed, Marilyn's estate may be prohibited from claiming the unused exclusion amount from Stephen's estate. Hence there could now be US estate tax in Marilyn's estate which may have been avoided if an estate tax return and appropriate election had been filed for Steven's estate.

Nonresident Alien Allowed to Carry Over Losses Generated While a US Resident

An individual who incurred business losses from sources within and without the US while he was a US resident was able to carry the losses over to deduct against US source business income when he became a non-resident. He was also allowed to carry the losses forward after he reacquired US resident status. (IRS Letter Ruling 201228013).

UPDATE ON FATCA!

The US Internal Revenue Service (IRS) offensive on US citizens living abroad that are not in compliance with US tax laws has more than one facet. Most readers are aware of the so-called offshore voluntary disclosure initiatives that have been in effect for the past few years in order to encourage US citizens abroad to comply.

Now, some Canadian banks and brokerage firms are already starting to ask their US citizen clients for their US Social Security numbers in preparation for the reporting they will have to make to the US Internal Revenue Service under the US tax law known as the "Foreign Account Tax Compliance Act - "FATCA"). These requests by banks and brokerage firms are putting increasing pressure on US citizens who have not complied with US filing requirements and who are in a dilemma about whether to comply, renounce US citizenship, or continue to ignore the issue.

Very simplistically, the FATCA law states that new US withholding rules will generally apply to certain non-US financial institutions, ("foreign financial institutions" - "FFIs"), including Canadian banks and brokerage firms. The FFIs can avoid the withholding if they enter into an agreement (FFI Agreement) with the IRS whereby they will report financial information on their US citizen clients to the Internal Revenue Service. Most financial institutions may want to enter into a FFI agreement because of the withholding tax consequences that would otherwise apply.

However it is difficult for many foreign financial institutions to comply with FATCA due to conflict of laws issues such as certain domestic privacy laws. For example some countries prohibit the collection of information necessary to satisfy the FATCA reporting provisions. Therefore on July 27th the US Treasury issued a FATCA model "Intergovernmental Agreement" ("IGA") which enables countries to avoid the requirements of FATCA if they enter into an IGA with the US. Governments who sign an IGA with the US will be exempt from entering into an FFI Agreement with the US as well as the withholding requirements of FATCA. The model agreement was developed in consultation with France, Germany, Italy, Spain, and United Kingdom.

Under an IGA, the foreign country itself would collect information required under FATCA and would transfer that information to the United States. There are two versions of the model IGA agreement - a reciprocal version and a nonreciprocal version. The reciprocal version is only available to countries with whom the United States has an income tax treaty or tax information exchange agreement. Under the reciprocal version the US will exchange currently collected information on accounts held in US financial institutions by residents of partner countries. The exchange would be automatic - i.e. one country would not wait for a request from the other country to provide information.

The Timing of Implementation of FATCA

The timing of the implementation of the FATCA rules involves an immense complexity of interrelated provisions. The US regulations contain implementation dates – see below. However it may be difficult for those dates to be achieved. A foreign financial institution will want to know whether or not its country (e.g. Canada) will enter into an IGA with United States, and the terms of that agreement, before it goes through the expense of negotiating with the IRS over an FFI agreement, and the expense of implementing the systems to comply with an FFI agreement.

However the current proposed regulations (consisting of 388 pages) contain the following implementation dates (REG-121647-10, February 15, 2012):

Limited Reporting of US Accounts. Limited reporting for US accounts will begin with respect to the calendar years 2013 and 2014 (i.e. the relevant limited reporting *to* the IRS will actually occur in 2014 and 2015. Under this limited reporting, only the name, address, the US taxpayer identification number of each US account holder, the account balance, and the account number are required to be reported. (Prop. Regs. §1.1471-4(d)(7)(ii)(A)).

Reporting of Gross Proceeds and Fixed Income. The reporting of fixed income amounts, such as interest, dividends and pensions, associated with US accounts will begin with respect to the calendar year 2015. In other words the first reporting of this information to the IRS will actually occur in 2016. Reporting of gross proceeds from the sale of property (for example securities) begins with respect to calendar year 2016. In other words the first reporting of this to the IRS will actually occur in 2017.

Grandfathered Obligations. The proposed regulations provide an exemption from FATCA withholding for obligations outstanding as of January 1, 2013. (Prop. Regs. §1.1471-2(b)(2)(iii)).

Due Diligence Required by Canadian Banks, Etc.

Canadian financial institutions (Canadian FFIs) will be required to perform "due diligence" to determine whether their account holders are US persons. Each FFI must identify each account holder as a "US" account holder or as a "non-US" account holder. (Prop. Regs. §1.1471-4(c)(2)). The amount of due diligence required depends on the type of account holder and whether the account is a pre-existing account or a new account.

Pre-Existing Accounts In General. For those account holders for which US indicia exist an FFI must obtain information from the account holder that documents the account holder's status. (Prop. Regs. §1.1471-4(c)(4)(i)((A)).

For accounts held by entities, an FFI must determine whether any of the shareholders or interest holders are US citizens or US residents.

(US indicia include identification of an account holder as a US resident or US citizen, a US place of birth, a US address, a US telephone number, standing instructions to transfer funds to a US account, a power of attorney or signatory authority granted to a person with a US address, or an "in-care-of" address or "hold mail" instruction where no other address is provided).

Pre-Existing Accounts of Individuals. The proposed regulations exempt from review pre-existing accounts of individuals with a balance or value of $50,000 or less. The exclusion is increased to $250,000 for certain insurance and annuity contracts. Also the proposed rules permit one-time-only electronic searches for US indicia for pre-existing accounts that exceed the $50,000 or $250,000 threshold but for which the value is $1 million or less. For accounts of more than $1 million an FFI must conduct an "enhanced review".

Pre-Existing Accounts of Entities. Pre-existing accounts of $250,000 or less would not be subject to review until the account exceeds $1 million. For accounts of more than $1 million an FFI would be required to report all substantial US owners or obtain a certificate that the entity does not have any substantial US owners.

New Accounts. New accounts of individuals will be subject to review of the information obtained under local KYC ("Know Your Client") rules at the opening of the account, and the FFI may generally rely on that documentation. If US indicia are present, the FFI must obtain additional documentation as to the individual's status. (Prop. Regs. §1.1471-4(c)(4)(i)).

In the case of accounts for entities, the FFI must obtain certification of the entities FATCA status. (Prop. Regs. §1.1471-4(c)(3)(i)).

US CITIZENS WITH PRIVATE CANADIAN CORPORATIONS

We previously reminded US citizens with private Canadian corporations of certain US tax obligations and potential US filing obligations including IRS form 5471.

However, additional tax obligations and US filing obligations arise under Internal Revenue Code Sections 956 and 6038B.

Certain Investments by the Canadian Corporation-IRC §956

Very simplistically, a "US shareholder" of a Canadian corporation that is a "controlled foreign corporation" (CFC), may be required to include additional income on his/her personal US income tax return if the Canadian corporation makes an investment in "US Property". (IRC §956(a)).

A "controlled foreign corporation" (CFC) means any foreign corporation if more than 50% of:

1) the total combined voting power of all classes of stock of such corporation entitled to vote, or

2) the total value of the stock of such corporation,

is owned or is considered as owned by "United States Shareholders" on any day during the taxable year of the corporation. (IRC §957(a)).

A "US Shareholder" is any US person who owns or is considered as owning 10% or more of the total combined voting power of all classes of stock entitled to vote of the corporation. (IRC §951(b)).

Example. Sam, a US citizen forms Canadian corporation X which accumulates $500,000 of retained earnings ("accumulated earnings and profits" for US purposes). The Canadian corporation now purchases US real estate ("US Property") for $350,000. On these limited facts, and unless an exception applies, Sam may have to report an additional $350,000 of income on his personal United States income tax return, even though it is the corporation that owns the real estate and not Sam.

An exception applies if the retained earnings of X have already been taxed in the US.

What Type of Property Is "US Property"? "US Property" is:

(A) tangible property located in the United States;

(B) stock of a domestic (US) Corporation;

(C) an obligation of a United States person; or

(D) any right to the use in the United States of -

i) a patent or copyright,

ii) an invention, model, or design (whether or not patented),

iii) a secret formula or process, or

iv) any other similar right,

which is acquired or developed by the CFC for use in the United States. (IRC §956(c)(1)).

Thus US shareholders must be aware of the potential for US tax when they borrow money from their corporations or pledge the shares of the corporation for a third party loan.

Exceptions.

Section 956(c)(2) of the Internal Revenue Code contains a long list of exceptions to the definition of the term "US Property", for this purpose.

Some of the most relevant exceptions for readers may be:

1) US government obligations, money, and bank deposits.

2) Obligations of unrelated corporations. (IRC §956(c)(2)(F)). Thus the CFC can purchase stock or debt of an "unrelated" US corporation without triggering the rules of Section 956. This exception does not apply to obligations of US persons that are not corporations.

3) Certain obligations arising out of the sale or processing of property. (IRC §956(c)(2)(C)). Thus, for example, if there is a sale of product by a Canadian parent to its US subsidiary, any "accounts receivable" arising out of the transaction would not necessarily trigger the rules of Section 956. However any part of the accounts receivable that remain outstanding for more than a reasonable period of time could be treated as an "investment in US property".

4) Obligations connected with providing services. (Reg. 1.956-2T(d)(i)(B)) A limited exception applies for an obligation arising when a CFC provides services to a US obligor.

The rules are complex. Please contact your tax advisor before taking any action.

Certain Transfers to the Canadian Corporation - IRC §6038B

US citizens who contribute property to their private Canadian corporation and maintain control of the corporation after the contribution, are potentially required to file IRS Form 926 to report the contribution. (IRC §6038B(a)(1)(A)). A similar obligation may apply to a contribution of property to a foreign partnership. (IRC §6038B(a)(1)(B)).

Two separate sets of penalties potentially apply:

First, there is a potential penalty of 10% of the fair market value of the property transferred if Form 926 is not filed by the due date of the tax return for the year of the transfer. The penalty is limited to $100,000, unless the failure to comply was due to intentional disregard. (IRC §6038B(c)).

Also, the statute of limitations (period of limitations for assessment of tax for that year) will not commence until three years after Form 926 is actually filed. Thus the IRS will be able to assess tax for that year at any time in the future if Form 926 is not filed.

Second, a 40% penalty may be imposed on any tax underpayment resulting from an undisclosed foreign financial asset understatement. (IRC §6662(j)).

Special Rule for Transfers of Cash. A transfer of cash to the Canadian corporation must potentially be reported on Form 926 if:

1) Immediately after the transfer the person holds directly, indirectly, or by attribution, at least 10% of the total voting power or the total value of the corporation, or

2) the amount of cash transferred including cash transferred by a related person, during the 12 month period ending on the date of the transfer exceeds $100,000. (Reg. §1.6038B-1(b)(3)).

RESIDENCY OF A TRUST

The determination of the residency of a trust can be important for several reasons. For example it affects whether the trust is taxed in the US, and if it is taxed in the US whether it is taxed on its worldwide income, or just its US source income.

In addition, the trust's status as a US resident or nonresident has an effect on the determination of the proper US tax withholding at source when the trust sells US real estate. For example the sale of US real estate by a foreign (non-US) trust would normally be subject to a US federal withholding tax of 10% of the amount realized (generally, the selling price). On the other hand, the sale of US real estate by a domestic (US) trust generally requires withholding of 35% of the gain allocable to foreign beneficiaries.

However the Canadian tax rules for determining the residency of the trust can conflict with the US rules. Therefore, when addressing the US portion of the tax matters the trust must be alert to the US rules.

Canadian Rules

The Supreme Court of Canada has affirmed that for Canadian income tax purposes a trust is resident where its central management and control is exercised. (St. Michael Trust Corp. v. The Queen, 2012 DTC 5063). The court stated that, "*as with corporations, residence of a trust should be determined by the principal that the trust resides for the purposes of the Act where "it's real business is carried on*". In the instant case, the non-Canadian trustee only had a limited role, whereas the main beneficiaries in Canada exercised the central management and control of the trust.

US Rules

A trust is taxed as a US trust (a "domestic trust") only if it meets both the "US court test" and the "control test". The present rules are found in Code Section 7701(a)(30)(e).

US Court Test. A trust is a domestic trust only if a court within the United States is "*able to exercise*" *primary supervision*" over the "*administration of the trust*". What does that mean?

"Able to exercise" means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust. (Regs. §301.7701-7(c)(3)(iii)).

"Primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust. A court may have primary supervision, notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property. (Regs. §301.7701-7(c)(3)(iv)).

"Administration of the trust" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions. (Regs. §301.7701-7(c)(3)(v)).

Thus, simply having jurisdiction over the trustee, a beneficiary, or trust property is not equal to having "primary supervision over the administration of the trust".

The Regulations provide the following examples:

Example 1. A, a United States citizen, creates a trust for the equal benefit of A's two children, both of whom are United States citizens. The trust instrument provides that DC, a domestic corporation, is to act as trustee of the trust and that the trust is to be administered in Country X, a foreign country. DC maintains a branch office in Country X with personnel authorized to act as trustees in Country X. The trust instrument provides that the law of State Y, a state within the United States, is to govern the interpretation of the trust. Under the law of Country X, a court within Country X is able to exercise primary supervision over the administration of the trust. Pursuant to the trust instrument, the Country X court applies the law of State Y to the trust. Under the terms of the trust instrument the trust is administered in Country X. No court within the United States is able to exercise primary supervision over the administration of the trust. The trust fails to satisfy the court test and therefore is a foreign trust.

Example 2. A, a United States citizen, creates a trust for A's own benefit and the benefit of A's spouse, B, a United States citizen. The trust instrument provides that the trust is to be administered in State Y, a state within the United States, by DC, a State Y corporation. The trust instrument further provides that in the event that a creditor sues the trustee in a United States court, the trust will automatically migrate from State Y to Country Z, a foreign country, so that no United States court will have jurisdiction over the trust. A court within the United States is not able to exercise primary supervision over the administration of the trust because the United States court's jurisdiction over the administration of the trust is automatically terminated in the event the court attempts to assert jurisdiction. Therefore, the trust fails to satisfy the court test from the time of its creation and is a foreign trust.

(Since the law and regulations focus on the administrative power of the courts and not on the governing law stipulated by the trust instrument, it could be important for the trust document to specifically stipulate the jurisdiction where the trust will be administered, in addition to the jurisdiction whose laws will be applied. In this manner you can help control whether the trust will be a domestic or foreign trust).

The regulations also contain four "bright-line" examples for meeting the "US court test" if you wish to do so:

1) The fiduciary appropriately registers the trust in a US court in accordance with Reg. §301.7701-7(c)(4)(i)(A),

2) A testamentary trust is established under a decedent's Will probated within the US (and other requirements are met),

3) A US court is petitioned to cause its administration to be subject to the primary supervision of the US court, or

4) There is co-supervision over the administration by the US court and a court of a foreign jurisdiction. (Reg. §301.7701-7(c)(4)(i)(D)).

For more information please refer to Reg. §301.7701-7(c)(4).

The Control Test. In addition, a trust is a domestic trust only if one or more US persons has the authority to control, by vote or otherwise, all substantial decisions of the trust. (A "US person" is a US citizen or resident, a US partnership, a US corporation, and a US (domestic) estate or trust). Thus the "control" need not be held by a fiduciary - it can be held by a trust "protector", or investment manager, for example.

The regulations contain the following examples.

Example 1. Trust is a testamentary trust with three fiduciaries, A, B, and C. A and B are United States citizens, and C is a nonresident alien. No persons except the fiduciaries have authority to make any decisions of the trust. The trust instrument provides that no substantial decisions of the trust can be made unless there is unanimity among the fiduciaries. The control test is not satisfied because United States persons do not control all the substantial decisions of the trust. No substantial decisions can be made without C's agreement.

Example 2. Assume the same facts as in Example 1, except that the trust instrument provides that all substantial decisions of the trust are to be decided by a majority vote among the fiduciaries. The control test is satisfied because a majority of the fiduciaries are United States persons and therefore United States persons control all the substantial decisions of the trust.

Example 3. Assume the same facts as in Example 2, except that the trust instrument directs that C is to make all of the trust's investment decisions, but that A and B may veto C's investment decisions. A and B cannot act to make the investment decisions on their own. The control test is not satisfied because the United States persons, A and B, do not have the power to make all of the substantial decisions of the trust.

Example 4. Assume the same facts as in Example 3, except A and B may accept or veto C's investment decisions and can make investments that C has not recommended. The control test is satisfied because the United States persons control all substantial decisions of the trust.

Example 5. X, a foreign corporation, conducts business in the United States through various branch operations. X has United States employees and has established a trust as part of a qualified employee benefit plan under section 401(a) for these employees. The trust is established under the laws of State A, and the trustee of the trust is B, a United States bank governed by the laws of State A. B holds legal title to the trust assets for the benefit of the trust beneficiaries. A plan committee makes decisions with respect to the plan and the trust. The plan committee can direct B's actions with regard to those decisions and under the governing documents B is not liable for those decisions. Members of the plan committee consist of United States persons and nonresident aliens, but nonresident aliens make up a majority of the plan committee. Decisions of the plan committee are made by majority vote. In addition, X retains the power to terminate the trust and to replace the United States trustee or to appoint additional trustees. This trust is deemed to satisfy the control test under paragraph (d)(1)(iv) of this section because B, a United States person, is the trust's only trustee. Any powers held by the plan committee or X are not considered under the safe harbor of paragraph (d)(1)(iv) of this section. In the event that X appoints additional trustees including foreign trustees, any powers held by such trustees must be considered in determining whether United States trustees control all substantial decisions made by the trustees of the trust.

(Therefore it may be advantageous for the trust instrument to include language addressing the issue of control over "substantial" decisions of the trust, in order to accomplish your objective with respect to whether you wish to have a US (domestic) or foreign trust).

Tax Treaty Override

Because of the difference in the Canadian and US rules, any given trust might be considered a resident of Canada under Canada's tax law and simultaneously a resident of the US under US tax law.

Article IV of the Canada/US tax treaty applies to trusts as well as to individuals, and thus may override the US domestic law described above. Unfortunately however there are no "tie-breaker" rules for trusts as in the case of individuals. The treaty simply says "*where ……… a trust …. is a resident of both Contracting States, the Competent Authorities of the States shall by mutual agreement endeavor to settle the question and to determine the mode of application of the Convention to such person*".

WHAT IS "REASONABLE CAUSE"

Many IRS penalties can be abated if the taxpayer can demonstrate "reasonable cause". Penalties can apply, for example, if a taxpayer fails to timely file a tax return, or to pay tax. (IRC §6651). With the recent avalanche of new penalties to which US taxpayers have become subject, the meaning of "reasonable cause" has become more important.

Certain regulations provide for the potential to avoid a penalty if there is a "showing of reasonable cause". (Reg. §301.6651-1(c)). A taxpayer who wishes to avoid the penalty based on reasonable cause must submit to the district director, or the director of the service center where the return is required to be filed, a written statement under penalty of perjury making an affirmative showing of the facts.

The regulations state - "*If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause*"*. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship…….*" (Reg. §301.6651-1(c)(1)).

In a recent court case the Tax Court overturned a late filing penalty on a taxpayer in circumstances where the taxpayer's accountant prepared the tax return and timely forwarded it to the taxpayer, the taxpayer signed the return, but then inadvertently filed it in his records instead of sending it to the IRS. Relevant factors in this case were that the non-filing was discovered upon filing an amended return, and in previous years the tax return had always been timely filed. (Ensyc Technologies, TC summary opinion 2012-55).

US ESTATE TAX AND TRANSFEREE LIABILITY

A recent court case addresses the amount of IRS interest to which an heir to an estate is liable when estate tax is not timely paid.

Readers are aware if a nonresident alien of the US passes away while owning "US situs assets", including US real estate, a US estate tax return must be filed if the gross value of the US situs assets exceeds $60,000. In the case of jointly owned property (joint ownership with right of survivorship and tenants by the entirety) the $60,000 threshold is evaluated by including the gross value of the property, not the "share" of the property owned by the decedent.

If any required estate tax is not paid it *becomes a lien on the gross estate of the decedent for 10 years from the date of death*, (except for such part of the gross estate that is used for the payment of debts etc.). (IRC§ 6324(a)(1)). However in certain cases a third-party buyer can obtain good title to the property.

Also, if the debt is not paid, the spouse, transferee, trustee etc. has a liability for the tax up to the value the property received. In the case of a beneficiary this is referred to as "transferee liability". (IRC §6324((a)(2)). Thus, in the case where the ten-year statute mentioned above has been exceeded, the IRS can still collect tax from an heir to the estate.

When estate tax is paid late the IRS imposes interest on the late payment. An heir to the estate, who receives property from the estate can be liable for this interest as well as the tax itself. Interest is generally compounded daily and therefore it can become a huge amount if the estate tax liability is not addressed for a considerable period of time.

In a recent case the combined estate tax and interest thereon exceeded the value of the property received by the heir! Thus the court had to address the question as to whether the transferee was liable for interest accrued beyond the value of the property received. Fortunately, the court decided that the heir's liability for both tax and interest was limited to the value of the property received. (Baptiste v Commissioner, 29 F3d 433).

US TAX ON TIERED PARTNERSHIPS

The perceived present low value of US real estate in certain areas of the United States has triggered an increase in US real estate purchases by Canadians. Since many of these purchases are for investment purposes various partnership structures and other forms of ownership are, in many cases, being used instead of direct individual ownership.

Readers are aware there is generally a US withholding tax at the time of sale of US real estate by a foreign individual or entity. (IRC §1445(a)).

However in the case of a partnership having foreign partners there is also a quarterly withholding requirement based on the partnership's effectively connected income attributable to foreign partners (including real estate sales as well as rental income and other business income - IRC §1446). Thus the rules overlap and Reg. §1.1446-3(c) provides co-ordination rules.

Section 1445.

With respect to a sale by:

1) A foreign partnership, - the FIRPTA withholding tax under Section 1445(a) is generally 10% of the amount realized,

2) A domestic partnership, - the FIRPTA withholding tax under section 1445(e) is waived in favor of the rules of Section 1446 (below) provided the rules of Section 1446 are complied with and the transaction is not a nonrecognition transaction.

Section 1446.

With respect to a sale by:

1) A foreign partnership, - the FIRPTA withholding tax under Section 1445(a) of 10% of the amount realized still applies, however the foreign partnership may credit the amount withheld under section 1445(a) against its section 1446 tax liability.

2) A domestic partnership, - as above the FIRPTA withholding tax under Section 1445(e) is waived in favor of the rules of Section 1446 (provided the rules of Section

1446 are complied with and the transaction is not a nonrecognition transaction).

This article addresses only the Section 1446 requirements - i.e, the quarterly tax withholding requirements.

The tax withholding rules can get complex if there is a series of partnerships in the ownership structure. For example Canadians can form a Canadian partnership to invest in a US partnership to invest in the US real estate. In this scenario the owner, the Canadian partnership, is referred to as the "upper-tier partnership". The US partnership is referred to as the "lower-tier partnership".

The US rules for the withholding tax under Section 1446 vary depending upon whether the partnership is a:

1) Domestic Partnership Owned by Domestic Partnership,

2) Domestic Partnership Owned by Foreign Partnership, or

3) Foreign Partnership Owned by Foreign Partnership.

At domestic partnership means a partnership created in the United States or under the law of the United States or of any state. (IRC §7701(a)(4). A foreign partnership is any partnership that is not a domestic partnership. (IRC §7701(a)(5).

Domestic Partnership Owned by Domestic Partnership

If an upper-tier domestic partnership directly owns an interest in the lower-tier partnership, the lower-tier partnership is not required to withhold Section 1446 tax quarterly with respect to the upper-tier partnership's allocable share of the income, regardless of whether the upper-tier domestic partnership's partners are foreign. (Regs. §1.1446-5(a)).

However an upper-tier domestic partnership may elect to apply "look through" rules to cause the lower-tier partnership to look through the upper-tier partnership to the partners for purposes of computing the lower-tier partnership's 1446 withholding tax liability. In other words, the withholding requirement in respect of the lower-tier partnership's income ultimately allocable to the ultimate foreign partners would be assigned to the lower-tier partnership. Various documentation requirements are required with respect to this election. (Regs. 1.1446-5(e)).

Domestic Partnership Owned by Foreign Partnership

Under the general rule a lower-tier (domestic) partnership would be required to withhold the Section 1446 tax quarterly on the basis of the full amount of the lower-tier partnership's income allocable to the upper-tier (foreign) partnership even though the foreign partnership may have some domestic partners.

However in computing its 1446 withholding requirement the lower-tier partnership may be able reduce its withholding tax requirement under the provision of Regs. §1.1446-5(c). In this scenario, the upper-tier (foreign) partnership remains obligated to comply with its own Section 1446 requirements. (Regs. §1.1446-5(c)(2)).

Extensive reporting rules are also found at Regs. 1.1446-5(b) and examples at Regs. 1.1446-5(f).

Special rules are provided for circumstances where a partnership required to withhold under Section 1446 may consider certain partner level deductions and losses in computing its 1446 tax obligation. (Regs. §1.1446-6).

Foreign Partnership Owned by Foreign Partnership

In the case of the lower-tier foreign partnership the normal Section 1446 rules would apply. Thus the lower-tier foreign partnership would be required to withhold and remit to the IRS the full amount of tax attributable to the upper-tier foreign partnership's interest even if the foreign upper-tier partnership has domestic partners. However the provisions of Regs. §1.1446-5(c) may also be available to reduce withholding in these circumstances.

Partnerships with a Grantor Trust As a Partner

If the partnership has a trust as a partner it will have to determine whether the trust is a domestic or foreign trust.

If the grantor or other person is treated as owner of a portion of the trust under US rules, it will be necessary to obtain documentation with respect to the owner. (See Reg's §1.1446-1(c)(2)(ii)(E)).

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