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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WINTER / SPRING, 2012

ADMINISTRATIVE/LEGISLATIVE/ JUDICIAL UPDATE

File a False Tax Return and Lose Your Green Card?

The United States Supreme Court has decided that making a false statement on a tax return constitutes a "deportable offense". As a result two green card holders who were convicted of making a false statement on a tax return were removed from the United States.

Under 8 U.S.C. Section 1101(a)(43) an individual with a green card can be deported if he/she has committed an "aggravated felony". An offense constitutes an "aggravated felony" if two requirements are met:

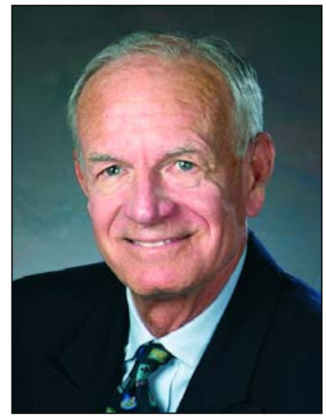
i) There was fraud or deceit, and

ii) The loss to the victim exceeds $10,000.

In the instant case the court decided both tests were met as a result of the false statement on the tax return and therefore the individuals were deported. (Kawashima v. Eric Holder, Docket No. 10-577, February 21, 2012, affirming 593 F. 3d 979).

Telecommuting Can Create Nexus for Your Employer

New Jersey determined that a Delaware corporation was subject to New Jersey corporation business tax because the corporation employed an individual who regularly and consistently telecommuted full-time from her New Jersey residence. The employee developed and wrote software from a laptop computer from her residence in New Jersey and then uploaded it to the employer's computer server in another state. The work performed was an integral part of the web-based service provided by the taxpayer to its customers. (Telebright Corporation, Inc. v. Director, Division of Taxation, Superior Court of New Jersey, Appellate Division, No. A-5096-09T2, March, 2012).



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's Executors Personally Liable for Deceased Taxpayer's Taxes

The executors of an estate were held to be personally liable for a decedent's unpaid income tax. The executors sold the decedent's property that was encumbered by a tax lien without first satisfying the tax lien. (D. A. Tyler, D.C. Pa.)

Estate Penalized For Not Filing IRS Forms 3520 for Decedent

A taxpayer who passed away had not filed several years of required IRS Forms 3520 and 3520-A. The estate subsequently filed the forms, but the IRS levied against the estate the normal late filing penalties that would have applied to the decedent. (CCA Letter Ruling 201208028, February 2012).

Out of State Call Center Might Have Nexus

The Illinois Department of Revenue has decided that an out-of-State call center business might have nexus for Illinois income tax if it engages independent contractors within Illinois in connection with its call center business. The Department concluded that the result in each case is highly fact-dependent and can only be determined by audit. But the Department stated if the business is entirely set around using independent contractors on a regular basis there likely would be nexus. (General Information Letter, IT 12-0001-GIL, Illinois Department of Revenue, January, 2012).

Flight Attendant Living Outside the US Required to Pro-Rate Exclusion

Readers are aware US citizens and certain US residents living outside the US are entitled to exclude certain wages from US income tax under the "foreign earned income" exclusion rule. The US Tax Court recently decided that a flight attendant living outside the US was only entitled to exclude a portion of her wages because the exclusion only applies to wages earned while in a foreign country. International airspace is not a "foreign county". Thus her foreign earned income exclusion was calculated using the airline's duty time apportionment tables. (C. J. LeTourneau, TC Memo, 2012-45).

CURRENCY TRANSACTIONS AND TRANSLATIONS FOR US TAXES

The requirement for currency translations for income tax purposes arises in many different circumstances. For example:

1) A Canadian corporation conducts US business in US dollars through a US branch,

2) A Canadian corporation conducts US business in US dollars through a US subsidiary,

3) A US corporation conducts Canadian business in Canadian dollars through a Canadian branch,

4) A US corporation conducts Canadian business in Canadian dollars through a Canadian subsidiary,

5) A US citizen resident in Canada buys or sells Canadian corporate stock or Canadian real estate which was denominated in Canadian dollars,

6) A US citizen resident in Canada buys or sells a Canadian corporate or government bond which was denominated in Canadian dollars,

7) A US citizen resident in Canada owns a private Canadian corporation and therefore must file IRS Form 5471 requiring translation of the Canadian financial statements into US dollars, and

8) A US citizen resident in Canada has a significant interest in a Canadian partnership and therefore must file IRS Form 8865 requiring translation of the Canadian financial statements into US dollars.

Of course many other examples exist.

A currency transaction may exist on the purchase and sale of foreign currency itself or on the purchase and sale of assets which are denominated in a foreign currency.

In general there are two issues to consider when a currency transaction occurs:

i) A determination of if and when gain or loss is realized and recognized and whether the income or loss is ordinary or capital, and

ii) The actual method required to translate activities denominated in foreign currency into US dollars.

Before applying any rules, the taxpayer's "functional currency" must be determined. The determination of a taxpayer's functional currency is the first step in the US tax analysis of transactions, because of the difference between US tax rules when a transaction occurs in the taxpayer's functional currency compared with the rules when a transaction occurs in a nonfunctional currency.

A taxpayer's functional currency is determined based on:

a) The taxpayer itself, or

b) Whether the taxpayer has a separate business operation referred to as a "Qualifying Business Unit". ("QBU").

For US income tax purposes:

i) The functional currency of a US citizen is generally the US dollar. (IRC §985(b)(1)(A)), and

ii) The functional currency of a QBU is generally the US dollar (IRC §985(b)(1)(A) and IRC §985(b)(2)), unless a significant part of its activities are conducted in an economic environment having and using a different currency, and that other currency is used in keeping its books and records. (IRC §985(b)(1)(B) and IRC §985(b)(2)). Thus if there is a QBU operating in Canada which keeps its books and records in Canadian dollars, the Canadian dollar is its functional currency. In some circumstances, a taxpayer whose functional currency is not the US dollar may elect to use the US dollar as its functional currency for a QBU. (IRC §985(b)(3)).

A qualified business unit (QBU) means "any separate and clearly identified unit of a trade or business of the taxpayer which maintains separate books and records". (IRC §989(a)).

A corporation is a QBU. An individual is not QBU. A partnership, trust, or estate is a QBU of a partner or beneficiary. (Regulation §1.989(a)-1)).

The *activities* of an individual, corporation, partnership, trust, estate, may qualify as a QBU if:

a) The activities constitute a trade or business, and

b) A separate set of books and records is maintained with respect to the activities.

Activities of an individual as an employee are not considered by themselves to constitute a trade or business for this purpose. However activities of an individual as a sole proprietor may constitute a trade or business. (Regs. §1.989 (a)-1(b)(3) and (c)).

Thus a US citizen resident in Canada will personally have the US dollar as his/her functional currency, except for certain clearly identified unincorporated trades or businesses which may be eligible to use the Canadian dollar as their functional currency. Therefore for US tax purposes, most such individuals must translate their Canadian transactions into US dollars in accordance with US currency translation rules. (See "***General Translation Rules***" below).

A nonfunctional currency is to be viewed, itself, as personal property, and therefore its disposition will normally (but not always) create a "market" gain or loss, even if the proceeds of the disposition are retained in the nonfunctional currency.

For example, if a US citizen sells a Canadian stock or Canadian land denominated in Canadian dollars there may be a market gain or loss to report for US income tax purposes. The gain or loss for US purposes would normally be the difference between the net sales proceeds expressed in US dollars reduced by US person's adjusted cost base, calculated and expressed in US dollars. In this example, if the currency rate changes between the date of acquisition and date of disposition, there could be a "market" gain or loss for US tax purposes, even if there was no gain or loss in Canadian dollars.

However in some circumstances there may be a "currency" (exchange) gain or loss in addition to a "market" gain or loss. Please see the Fall, 2011, issue of "*Brunton's US Taxletter for Canadians*" for a summary of IRC §988 for some examples of when there can simultaneously be a market gain or loss and a currency (exchange) gain or loss.

"Market" Gain Versus "Currency" (Exchange) Gain

The terms "currency" gain or loss and "exchange" gain or loss are interchangeable and hereafter we use the expression "exchange" gain or loss.

When a taxpayer has a transaction occurring in a nonfunctional currency (for example a US citizen resident in Canada has a transaction in Canadian dollars) it is important to determine whether any gain or loss for US income tax purposes is solely a "market" gain or whether there is both a "market" gain or loss and also an "exchange" gain or loss.

This is important because the market gain or loss will often be a capital gain or loss, whereas the exchange gain will often be an ordinary gain or loss. Generally speaking, the determination of whether there is any exchange gain will depend on whether or not the transaction is a "Section 988" (§988) transaction. (Please see the Fall, 2011, issue of "*Brunton's US Taxletter for Canadians*" for a brief summary of Section 988 transactions).

Simplistically a Section 988 transaction means any of the following transactions if the taxpayer is entitled to receive (or is required to pay) by reason of the transaction, an amount that is denominated in a non-functional currency, or is determined by reference to a non-functional currency:

a) The acquisition of a debt instrument or becoming the obligor under a debt instrument,

b) Accruing any item or expense or gross income or receipts which is to be paid or received after the date on which it is accrued or taken into account,

c) Entering into or acquiring any forward contracts, futures contract option, or similar financial instrument (IRC §988(c)(1)). Various exceptions apply.

As summarized in the Fall, 2011, issue of "*Brunton's US Taxletter for Canadians*" the purchase and sale of debt instruments (bonds, notes, treasury bills, etc.) denominated in Canadian dollars, would generally be Section 988 transactions for US income tax purposes, and therefore possibly give rise to exchange gain or loss.

Exchange Gain or Loss

As indicated above, there may be an "exchange" gain or loss as well as a "market" gain or loss when a transaction occurs in a nonfunctional currency. Unlike "market" gain or loss, which, depending on the circumstances, may be treated as capital gain or loss, **or** ordinary gain or loss, an "exchange" gain or loss is generally taxed as ordinary gain or loss. (IRC §988(a)(1)(A), IRC §988(b), and 988(c)1)(C)(i)).

Functional Currency Transactions. Of course when a transaction occurs solely within the functional currency (as distinguished from the nonfunctional currency) an exchange gain or loss never occurs although there may be a market gain or loss. For example, if a US citizen resident in Canada has a securities account denominated in US dollars and sells securities (stocks or bonds) in this account, there would generally be no exchange gain or loss for US tax purposes on a transaction in the account even though there may be a "market" gain or loss.

Nonfunctional Currency Transactions. However the sale of certain assets (e.g. certain debt instruments) denominated in a nonfunctional currency (e.g. denominated in Canadian dollars in the case of a US citizen whose functional currency is the US dollar) may create an "exchange" gain or loss for US tax purposes, in addition to a "market" gain or loss. (See IRC §988). For example a US citizen resident in Canada who sells a Canadian bond, may have an exchange gain or loss as well as a market gain or loss. On the other hand, if the transaction is not a Section 988 transaction (for example the sale of land or a stock), there will likely only be a market gain or loss. However even if it is a Section 988 transaction there will be no exchange gain or loss recognized in the case of the following transactions:

i) An exchange of units of nonfunctional currency for different units of the same nonfunctional currency, (one example might be the movement of nonfunctional currency, say Canadian dollars, from one Canadian dollar bank account to another Canadian dollar bank account),

ii) The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency,

iii) The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency,

iv) The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument, and

v) The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution. (Regs. §1.988(2)(a)(1)).

However the taxpayer must keep track of his/her adjusted basis (adjusted cost base) in the nonfunctional currency. The taxpayer's basis in the (new) nonfunctional currency is the adjusted basis of the units of the nonfunctional currency transferred.

Limited Exemption For Transactions Of An Individual. Certain personal currency transactions of an individual will not result in an exchange gain or loss. Such transactions of an individual will only result in exchange gain or loss to the extent the expenses associated with the transaction are deductible under IRC §162 or IRC §212, except for IRC §212(3). (IRC section 988(e) and Regs. §1.988-1(a)(9)). For example the repayment by a US citizen, resident in Canada, of a home mortgage in Canada denominated in Canadian dollars would normally not result in an exchange gain or loss.

General Translation Rules

Branch Activities. With respect to 3) above (*A US corporation conducts Canadian business in Canadian dollars through a Canadian branch*), assuming the branch is a QBU and the Canadian dollar is the functional currency, the profit or loss must be computed first in Canadian dollars, (with adjustments made to take into account US tax accounting principles), and the result is translated into US dollars at "the appropriate exchange rate". (IRC §987). The expression "appropriate exchange rate" is defined for various circumstances in section IRC §989(b). For purposes of translation of branch profits the "appropriate exchange rate" is the "average exchange rate" for the period. (IRC §987(1) and (2), and IRC §989 (b)(4). See also PLR 8920062).

Remittances from the branch are a realization event causing an exchange gain or loss for US tax purposes. The actual remittance will create an exchange gain or loss based on the difference between the current US dollar value of the remittance and the dollar value of the remitted funds at the time such funds were contributed to, or earned by, the branch. The US dollar value of remitted funds when earned is computed with respect to the branch's US dollar earnings as reported on its US income tax return. A similar computation would be made if the branch terminates.

These rules would also apply to a foreign entity that has made a "check-the-box" election.

Foreign Subsidiary That Is Not A CFC. The rules described above under "branch activities" also generally apply to determine the "current earnings and profits" of a foreign corporation, regardless of whether or not it is a controlled foreign corporation (CFC). In other words the earnings are determined in the corporation's functional currency. (IRC §986 (b)(1)).

When the earnings are distributed they are translated into US dollars using the "appropriate US exchange rate". (IRC §986(b). The "appropriate exchange rate" in this case is the spot rate on the date the distribution is included in income of the recipient. (IRC §989(b)(1)).

Thus no exchange gain or loss is recognized with respect to distributions from a foreign subsidiary or from the sale of shares or liquidation of the subsidiary, as long as it is not a CFC. (Of course there may be a "market" gain or loss on the liquidation).

A CFC That Has "Subpart F" Income. As indicated above, the earnings of a CFC are determined in the corporation's functional currency. (IRC §986(b)(1)).

If a CFC has Section 951 ("Subpart F") income which requires a deemed distribution to be included in the US shareholder's income, the amount to be included in income under Section 951(a)(1)(A) or Section 1293(a) is the earnings in the functional currency translated at the "averaged" rate. (IRC §989(b)(3)). The regulations determine "averaged" to mean the simple average of the daily exchange rates, excluding weekends, holidays, and any other non-business days for the taxable year). (Reg. §1.989 (b)-(1)).

When those earnings are ultimately distributed to the shareholder the distribution of that income may create an exchange gain or loss to the shareholder. "*Foreign currency gain or loss with respect to distributions of previously taxed earnings and profits (as described in section 959 or 1293 (c)) attributable to movements in exchange rates between the times of deemed 951 income and actual distribution of the income shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion*". (IRC §986(c)(1)).

When the related income is actually distributed to the shareholder it is translated into US dollars at the spot rate on the day the income is included in income of the shareholder. (IRC §989(b)(1)). It is then compared to the US dollar basis of the previously taxed income (PTI) that is being distributed, to determine the exchange gain or loss.

US dollar basis of undistributed PTI is determined as follows:

1) Compute the total §951(a)(1) income (the "Subpart F" income) from the corporation for all post-1986 tax years in both US dollars and functional currency terms. (Notice 88-71).

2) From the US dollar amount of post-1986 §951(a)(1) income, subtract the US dollar amount of prior distributions of post-1986 previously taxed income (PTI) of the CFC.

3) The result is the US dollar basis of undistributed PTI.

In computing the exchange gain or loss on the distribution, the exchange gain or loss must be determined separately for each separate limitation category as defined under Regs. §1.904-5(a)(1). (Notice 88-71).

Please also see the article "***CURRENCY TRANSLATIONS FOR FORM 5471***".

THE "HIGH TAX KICK OUT"

An important component of the income tax computation for many cross-border transactions, (including income received by a resident of one country from a source in another country), is the computation of foreign tax credits. In computing the foreign tax credit on a US income tax return, the non-US income (foreign source income), and the foreign tax thereon, must be assigned to an appropriate "category". For US taxation, the most commonly relevant categories for individuals are the "passive" category, and the "general" category. Foreign tax assigned to one category can only be offset against US tax applicable to that category.

The category into which a specific amount of foreign income is assigned can have a dramatic effect on the ultimate net US tax liability. One reason is that the taxpayer may have substantial unused foreign tax credits in one category and not the other, thus perhaps resulting in little or no US tax if the income is assigned to the first category, but substantial tax if the foreign income is assigned to the latter category.

Simplistically, the "passive" category generally includes any income received or accrued that constitutes dividends, interest, royalties, rents, annuities, certain gains from the sale or exchange of property, foreign currency gains, and personal service contracts. For a thorough description please see IRC §904(d), IRC §954(c), and the regulations thereunder. Many exceptions apply.

The "general" category includes any income not assigned to another category.

High-Taxed Income

It is important to properly identify "high-taxed income" because it is assigned to the "general" category, even if it would otherwise be assigned to the "passive" category. (IRC §904(d)(2)(B)(iii)). In other words, even if it would normally be in the passive category it is "kicked-out" to the general category. This requirement is often referred to as the "high-tax-kick-out". (HTKO). The HTKO occurs if "the sum of the foreign tax on the foreign passive income exceeds the highest US federal tax rate on that income multiplied by the amount of income". (IRC §904(d)(2)(F)).

The associated foreign taxes are also "kicked-out" to the general category.

The HTKO does not require an item by item examination of the rate of foreign tax imposed. (H. R. Conference Report No. 99-841, Section II-586, issued in 1986).

The procedure is as follows:

1) First, the foreign source passive income is allocated into separate groups (Regs. §1.904-4(c)(1)).

2) The taxpayer's expenses, losses and other deductions are allocated and apportioned to each group, to determine foreign source taxable income for each group,

3) The foreign source passive taxable income for each group is then multiplied by the highest US federal tax rate (generally 35% in the case of individuals - but see "Dividends and Capital Gains" below),

4) The tax in 3) above is compared with the actual foreign tax liability for that group.

Grouping Rules

The foreign source passive income is assigned to groups and the HTKO rule is subsequently applied to each separate group . There are three sets of grouping rules:

1) General rules,

2) Rules for income received from a controlled foreign corporation (CFC) or a qualified business unit, (QBU), and

3) Rules for certain rents and royalties, distributive shares of partnership income, and foreign currency gains and losses on previously taxed income.

Passive income falling under the general rules are allocated to groups according to the foreign taxes imposed on the income as follows:

1) All passive income subject to a foreign withholding tax of 15% of greater,

2) All passive income subject to foreign withholding tax of less than 15% but greater than zero,

3) All passive income that is not subject to foreign withholding tax or any other foreign tax,

4) All passive income that is not subject to foreign withholding tax but ***is*** subject to a foreign tax. (Regs. §1.904-4 (c) (3)).

Once the groups have been determined the taxpayer's expenses, losses and other deductions are allocated and apportioned to each group before applying the kick-out test. (Regs. §1.904-4(c)(2)(ii)(A)).

For the other rules (associated with income from CFCs, QBU's, rents royalties etc.), please see Regs. §1.904-4(c)(4) and 1.904-4(c)(5).

Dividends and Capital Gains

As indicated above, the foreign source passive taxable income in each group is multiplied by the highest US tax rate to determine if the HTKO applies. For individuals the tax code states that the highest rate of tax is defined as the highest rate of tax specified in Code Section 1.

However Section 1 applies different "highest maximum" rates to individuals:

1) 35% on "ordinary" income, and

2) A maximum 15% on "qualified dividends" and certain long-term capital gains.

Thus the question arises whether a taxpayer who is required (or wanting) to shift income and tax from the passive category to the general category, would apply the HTKO rule using a 15% rate for the "highest US tax rate" in connection with foreign source (non-US source) qualified dividends and long-term capital gains.

The assumed underlying rationale for the origin of the HTKO is that the Congress intended that income be "kicked out" into the general category whenever the foreign tax rate on the income was higher than the domestic tax rate. Therefore this assumed congressional intent would seem to argue for using the capital gains rate (maximum 15% at the moment on cerain long-term gains) to make the HTKO determination for qualified dividends and certain long-term capital gains. However there is apparently no authority for proceeding on that basis.

In addition, perhaps consideration should be given to Canada's special treatment of dividends and capital gains. Given that Canada generally taxes one half of capital gains, should the foreign (Canadian) tax rate take this into consideration. Similarly, the computation of the Canadian tax rate on dividends from Canadian corporations should perhaps take into consideration the "gross up" of the dividend and the dividend tax credit that applies to dividends from Canadian corporations for Canadian income tax purposes.

CURRENCY TRANSLATIONS FOR FORM 5471

Readers are aware that US citizens and US residents are required to attach IRS Form 5471 to their US income tax return if they have a certain specified involvement with a non-US corporation. A penalty of $10,000 potentially applies for each year for each corporation for which a required 5471 is not timely filed. In addition, the statute of limitations may not commence for a particular year until all required Forms 5471 for that year have been filed.

Form 5471 requires the corporation's income statement (Schedule C) and balance sheet (Schedule F) as well as information on schedules E, H, I, M, and O all to be expressed in US dollars even if the functional currency of the corporation is not the US dollar. Specific rules must be used for these currency translations. Schedules B and M also require you to state the currency "conversion"/ translation rate used on the form.

In expressing the translation rate, the instructions require you to use the "divide-by convention" (i.e. the amount by which the functional currency amount must be "divided by" in order to reflect an equivalent amount in US dollars. Thus the exchange rate to be reported is the units of foreign currency (for example Canadian dollars) that equal one US dollar). That number must be rounded to at least four places.

According to the instructions to Form 5471 amounts required to be translated to US dollars must be done so under the following rules:

Schedules C (Income Statement) and F (Balance Sheet. These amounts must be translated to US dollars as prescribed by "generally accepted accounting principles" (GAAP). Please see the article ***"GAAP's CURRENCY TRANSLATION RULES".***

Schedules E, H, and M. These amounts must be translated using the "appropriate exchange rate" as defined in Section 989(b). (i.e. the average exchange rate for the year).

GAAP's CURRENCY TRANSLATION RULES

As indicated in the article ***"CURRENCY TRANSLATIONS FOR FORM 5471"*** US "generally accepted accounting principles" (GAAP) are used to determine currency translation rules for certain sections of Form 5471. These rules are set out in "*Statement of Financial Accounting Standards No. 52* *(FAS 52)*, issued by the "Financial Accounting Standards Board" of The Financial Accounting Foundation.

FAS 52 makes a distinction between:
1) Transaction gains and losses, and
2) Translation adjustments.

Transaction Gains and Losses

Transaction gains and losses arise from the effect of exchange rate changes on transactions denominated currencies other than the functional currency (i.e. "foreign currency transactions"). For example, if the functional currency is the Canadian dollar, a transaction in US dollars creates income or loss for the corporation for US Form 5471 purposes. The definition of functional currency under GAAP is similar to the Internal Revenue Code definition of functional currency. See FAS 52, Appendix A.

All elements of financial statements must be translated by using a prescribed exchange rate. (FASB 52, paragraph 12).

"*Assets and liabilities shall be translated at the exchange rate at the balance sheet date*". (FASB 52, paragraph 12).

"*For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements*". (FASB 52, paragraph 12).

Translation Adjustments.

If an entity's functional currency is a foreign currency, a "translation adjustment" results from the process of translating the entity's financial statements into the reporting currency. (FASB 52, paragraph 13). This occurs because the income statement is translated at an "appropriately weighted average" exchange rate for the period while the balance sheet is translated at the year-end rate, and thus the balance sheet will not balance. This is offset by a "translation adjustment" which is not included in net income but is reported separately and accumulated as a separate component of equity. (FAS 52, paragraph 13). At the time of sale or complete or substantially complete liquidation of the investment in the entity, the amount recorded in the translation adjustment account is to be reported as part of the gain or loss on the liquidation of the investment. (FAS 52, paragraph 14).

Under GAAP, disclosure must be made of:

1) The beginning and ending amount of cumulative translation adjustments,

2) The aggregate adjustment for the period resulting from translation adjustments, and

3) The amount of income taxes for the period allocated to translation adjustments (see FASB 52, paragraph 24). (FASB 52, paragraph 31).

As indicated, foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. For example, for a Canadian corporation whose functional currency is the Canadian dollar, a transaction in US dollars would be a foreign currency transaction. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in exchange rates between the two currencies in such a transaction would create a transaction gain or loss that generally must be included in income for the period in which the exchange rate changes. (FAS 52, paragraph 15).

Certain transaction gains and losses are to be excluded from current net income including certain intercompany foreign currency transactions that are of a long-term nature. Please see FAS 52, paragraphs 20 and 21.

LENDING MONEY TO YOUR US SUBSIDIARY

Canadian entities conducting business in the US through a US subsidiary will often fund the US subsidiary via a loan from the Canadian parent. Some issues governing the US income taxation of this structure, where applicable, are the US rules for "thin capitalization", imputed interest, denial of accrued but unpaid interest to related parties, and the rule of Internal Revenue Code Section 163(j) (commonly referred to as the "interest stripping" rule). The interest stripping rule potentially limits the interest deduction for the US subsidiary if it has "excess interest" paid to a "related party".

Assuming there would otherwise be no US tax on the interest paid to the Canadian parent (which would normally be the rule under the Canada-US tax treaty) in general the US subsidiary ("Sub") is not allowed to deduct its "disqualified interest" in the current year if the Sub:

1) Has "excess interest" expense for year, and

2) The ratio of debt to equity of the Sub exceeds 1.5 to 1 (either at the year end or at any date during the year prescribed by regulations).

Any disqualified interest can be carried forward to the subsequent year.

Excess Interest

The expression "excess interest" means the excess, if any, of:

1) The corporation's net interest expense, over

2) The sum of 50% of the adjusted taxable income of the corporation plus any so called "excess limitation carryforward". (See IRC §163(j)(2(B)(ii)).

The rules are complex - please consult your tax advisor before taking any action.

PUBLISHED THREE TIMES PER YEAR BY TAX REPORTS INC.
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