

TaxTalk

U.S. TAX UP-DATE

As with recent Canadian tax law, there have been a number of U.S. tax developments, which may impact Canadian residents. This TaxTalk discusses some of the recent changes in the U.S., together with various U.S. reporting requirements for Canadian residents that we believe will be of most interest to our clients. The discussion focuses on issues relevant to Canadian resident individuals, including U.S. citizens living in Canada, and Canadian corporations currently or anticipating carrying on business in the U.S.

TABLE OF CONTENTS

U.S. Income Tax Filing Requirements for Canadian Residents/Citizens	Page 1
U.S. Income Tax Filing Requirements for U.S. Citizens Living In Canada	Page 4
U.S. Estate Tax for Canadian Residents/ Citizens	Page 8
Canadian Corporations Doing Business in the U.S.	Page 9

U.S. INCOME TAX FILING REQUIREMENTS FOR CANADIAN RESIDENTS/CITIZENS

Certain Canadian residents may be required to file U.S. income tax returns. The list of Canadian residents includes Canadians who: [i] spend a good deal of time in the U.S., [ii] are members of partnerships that own U.S. real property interests, [iii] carry on a business in the U.S., [iv] are employed in the U.S., or [v] are beneficiaries of U.S. trusts.

In general, individuals who meet the “substantial presence” test¹ are considered to be “resident aliens” for U.S. tax purposes. Resident aliens are generally subject to tax in the U.S. on their **worldwide income, and must² file a U.S. income tax return.**

In contrast, **non-residents of the U.S.** (non-resident aliens) are subject to U.S. tax only on their U.S. source income and income effectively connected with a U.S. trade or business. For some types of income, e.g. investment income, there is U.S. withholding tax, and it is not necessary for a U.S. tax return to be filed. For other types of U.S. source income / activity, e.g. rental income, sales of U.S. real estate and business income earned in the U.S., a non-resident is required to file a U.S. tax return in respect of these types of income.

In the event an individual is a resident of both Canada and the U.S. there are “tie breaker” rules³ under the Canada-U.S. Tax Convention that determine which country the individual will be considered to be a resident for tax purposes.

¹ Under the substantial presence test, an individual is considered to be a U.S. resident for tax purposes for a taxation year if the individual is physically present in the U.S. at least 31 days during the year **and** 183 days during the current and 2 preceding years, counting all the days in the current year and 1/3 of the days present in the U.S. in the immediately preceding year and 1/6 days present in the U.S. in the second preceding year.

² Administratively, the IRS allows Canadian residents who meet the substantial presence test to file a closer connection exemption form in lieu of filing a U.S. tax return.

The following provides comments that may be of interest to Canadian residents earning income in or from the U.S.

i. U.S. Individual Taxpayer Identification Number (ITIN)

Many Canadian resident taxpayers must obtain an ITIN for U.S. tax purposes. All individuals [i] who are required to file U.S. income tax returns or [ii] who have filed U.S. withholding tax exemption certificates are required to have either a U.S. Social Security Number (SSN) or an ITIN.

U.S. citizens, green card holders and individuals working in the U.S. under work visas or permits are issued SSNs. All other individuals, including non-residents and spouses and dependants of U.S. residents who are not eligible to obtain a SSN, are required to obtain an ITIN. An ITIN is an identification number used for tax purposes only.

Individuals requiring an ITIN number must file Form W-7, *Application for IRS Individual Taxpayer Identification Number*, and provide original documentation⁴ to substantiate their foreign status and true identity to the Internal Revenue Service (IRS). The IRS also has authorized "Acceptance Agents" who may certify and send the application to the IRS to obtain the ITIN for the taxpayer. **McCarney Greenwood LLP** is an authorized Acceptance Agent and can assist individuals in obtaining ITINs.

ii. Canadians Working in the U.S.

Canadians who work or provide services **in the U.S.** may be subject to U.S. tax on the portion of their salaries and business incomes that are attributable to those services provided in the U.S. As such, they would be required to file a U.S. tax return.

Individuals who spend more than 183 days in the U.S. in any particular year while working for a **Canadian employer** which does **not** have a place of business in the U.S., will be subject to U.S. tax on the portion of their salary earned while they are physically present in the U.S.

Canadians working in the U.S. for **U.S. employers** are liable to file a U.S. tax return and pay U.S. tax on the salaries related to the U.S. work, regardless of the time that they actually spend in the U.S.

Although any U.S. tax paid can be claimed to reduce/eliminate Canadian tax due on this income, a U.S. tax return will still need to be filed and the U.S. taxes owing will need to be paid in respect of this income.⁵ The returns are required to be filed by April 15th of the following year.

iii. U.S. Rental Income

Canadian residents who own U.S. property and rent the property out on a part-time or full-time basis are subject to U.S. income tax on the rental income. Rental income received by a Canadian resident is subject to a 30% U.S. withholding tax (based on the gross rental revenue) to be withheld by either the property management agent in the U.S. or the U.S. tenant. In order to avoid the withholding tax, a Canadian resident can apply for an ITIN (see discussion above) to file a U.S. non-resident income tax return (Form 1040NR) to report the U.S. rental income and expenses.

³ In general, the treaty tie-breaker rules consider the person's permanent home and/or the country with which his or her personal and economic relations are closer (centre of vital interests).

⁴ Requisite original documentation includes birth certificate and photo identification, e.g. passport, driver's licence etc.

⁵ Under the Canada – U.S. Tax Convention, Canadians, who earned compensation not exceeding US\$10,000, were not present in the U.S. more than 183 days in the calendar year and worked for a Canadian company that did not have a fixed place of business in the U.S., are **not** subject to U.S. taxation on these earnings. There is no requirement to file a U.S. tax return in respect of this income.

By filing the return, U.S. tax would apply to the *net* rental income. Any U.S. tax paid could be claimed on the taxpayer's Canadian tax return to reduce Canadian income tax payable in respect of the net rental income.

In many cases, Canadian residents would not owe any U.S. taxes with respect to U.S. rental properties since, under U.S. tax law, depreciation **must** be deducted each year in the determination of net rental income. This differs from Canadian tax law, under which tax depreciation (capital cost allowance) is a discretionary deduction and may only be claimed to the extent it reduces net rental income to nil. For U.S. tax filings, rental losses may be carried forward and may reduce future rental incomes and/or future gains, if any, on the ultimate sale of the property.

Trap for the unwary: It is important to note that non-resident taxpayers are allowed to claim rental expenses only if their U.S. income tax return is filed on a *timely basis*. The IRS may deny the expenses if a return is late filed by more than 16 months.⁶ If the expenses are denied by the IRS, U.S. tax will be payable on the *gross* rental income received in the year, which could result in significant double-tax being payable in respect of the U.S. rental income.

iv. Gambling and Racing Winnings

In general, gambling and racing winnings paid to a non-resident of the U.S. are subject to a U.S. federal withholding tax of 30%. This tax is **not** eligible as a foreign tax credit to reduce Canadian income taxes payable since these types of winnings are not taxed in Canada. Non-residents of the U.S. who have had U.S. tax withheld on their winnings may, however, be able to file a U.S. non-resident income tax return⁷ to report net income (i.e. winnings less losses and expenses) and claim a refund of part or all of the tax withheld on their winnings.

v. Capital Gains on Sales of U.S. Real Estate

When U.S. real estate is sold by a non-resident of the U.S., a 10% withholding tax⁸ will be applied to the *gross* proceeds. A U.S. non-resident income tax return must be filed to report any gain (or loss) on the disposition and compute U.S. taxes payable. The tax withheld on the sale will be credited against final U.S. taxes payable on the sale. Alternatively, any withholding tax in excess of the final U.S. taxes payable will be refunded.

vi. Capital Gains on Sales of U.S. Investments

Sales of shares of U.S. corporations, regardless of where they are traded, are generally **not** subject to U.S. tax if sold by a non-resident of the U.S. or a non-U.S. citizen. Thus, it is not necessary to file a U.S. tax return in respect of these disposals.

vii. U.S. Social Security Benefits

Under the Canada-U.S. Tax Convention (Treaty), Canadian residents who receive U.S. Social Security benefits are **not** subject to U.S. withholding tax on these amounts, i.e. the amounts are not taxable in the U.S. These U.S. benefits are, however, subject to Canadian income tax, but only on 85% of the benefits received.

⁶ To encourage filing of the tax returns, the IRS recently announced that it is waiving the 16-month filing deadline for prior U. S. returns if returns are **filed before September 15, 2003**.

⁷ Gambling winnings may be reported as business income when filing a U.S. tax return, and may be offset by losses and related expenses if the expenses are supported by receipts. The non-resident may need to substantiate that they are in fact in the business of gambling if they file to report their gambling activities as business income.

⁸ Under certain circumstances, application may be made to the IRS to reduce the 10% withholding tax, e.g. when it is expected that the actual tax payable on the disposition will be less than the 10% withholding tax or when the purchaser plans to reside in the property.

U.S. INCOME TAX FILING REQUIREMENTS FOR U.S. CITIZENS LIVING IN CANADA

Under **Canadian** tax law, only Canadian residents are subject to Canadian tax on their worldwide income, i.e. the Canadian tax system is based on residency. Non-residents of Canada (including Canadian citizens) are only subject to Canadian income tax on certain income from Canadian sources.

U.S. tax rules for individual taxpayers differ from the Canadian rules in that they are based on residency and citizenship. As such, **U.S. citizens living outside the U.S. are required to file** annual U.S. federal income tax returns and report their worldwide income to the Internal Revenue Service (IRS) as if they were still resident in the U.S. An individual is generally considered to be a U.S. citizen if they were born in the U.S., or became naturalized in the U.S.⁹ These returns are due by June 15th of the following year.

This filing obligation exists, even if the U.S. income tax liability is minimal (for instance, due to the foreign earned income exclusion and/or foreign tax credits - see discussion below).

Trap for the Unwary: There is no limitation period for non-filing of returns by non resident U.S. citizens - in theory, tax, penalty, and interest could be assessed for any prior delinquent years. However, we understand that the current administrative policy of the IRS is to generally require returns from a non-filer for only *six years*, and the late-filing penalties could be waived if the individual voluntarily contacts the IRS with reasonable cause for their failure to file prior year returns.

With increased technology and increased information sharing between Canada and the U.S., the chances of a non-filer being detected by U.S. tax authorities are mounting, e.g. especially at the time U.S. citizens living abroad renew their passports. With passport renewals, an IRS information return must be filed. Failure to file the return when requested by the IRS could result in criminal penalties.

The following provides comments that may be of interest to U.S. non-resident citizens in respect of their requisite U.S. tax returns.

i. Foreign Earned Income Exclusion

In filing their U.S. returns, *non-resident U.S. citizens* may qualify to exclude all or part of their “foreign earned income” from total income for U.S. tax purposes. The maximum exclusion amount for 2003 is US\$82,000 (US\$80,000 in 2002). Foreign earned income includes wages, salaries and business income received for service provided in a foreign country. Interest and dividend income, pension or annuity payments and social security benefits are not exempt as they do *not* qualify as earned income.

Trap for the unwary: Even if a foreign earned income exclusion causes there to be no U.S. tax liability, a U.S. tax return must still be filed. Failure to file could lead to significant U.S. tax, penalties etc.

ii. Foreign Tax Credit

To avoid double taxation, U.S. citizens living outside the U.S. are allowed to claim a foreign tax credit on their U.S. return for Canadian taxes paid on Canadian-source income to reduce/offset any U.S. tax that must also be paid on this income. The credit cannot exceed the Canadian taxes paid on the income. Any excess Canadian tax paid in any taxation year can be carried back two years and forward five years for U.S. tax purposes to offset excess U.S. tax on the Canadian source income in the carryover years.

⁹ A green card holder is also taxed in the U.S. on their world-wide income.

iii. Alternative Minimum Tax

The U.S. alternative minimum tax (“AMT”) attempts to ensure that U.S. citizens/green card holders with high gross income cannot avoid all U.S. tax liabilities by using exclusions, deductions and credits. For 2002, AMT generally arose when income on the U.S. return exceeded US\$112,500¹⁰ (if filing as a single taxpayer, US\$150,000 if married filing jointly).

Although the AMT can be reduced by foreign (e.g. Canadian) taxes paid, the reduction is restricted to 90% of the AMT liability, and thus, taxpayers in this situation end up incurring U.S. tax equal to 10% of U.S. AMT. There is no remedy to avoid the remaining AMT, and Canada does **not** allow a foreign tax credit for this AMT paid.

Although this AMT represents double-tax and is unfair to U.S. citizens living outside the U.S., the U.S. Federal Tax Court has ruled that the Canada-U.S. Tax Convention does **not** mitigate the U.S. AMT and thus does **not** provide relief for double taxation. The IRS has blatantly stated that the annual AMT liability payable by some high-income expatriate U.S. citizens and green card holders is the ‘cost’ they must pay to be Americans while abroad.

iv. Capital Gains and Capital Losses

The Canadian and U.S. tax rules with regard to capital gains and losses differ. As a result, additional tax may be incurred in respect of capital gains realized by U.S. citizens resident in Canada. The discussion below provides a brief overview of the Canadian and U.S. rules.

In general, only one-half of capital gains are subject to Canadian income tax, regardless of how long the property is held. U.S. capital gains tax rules are more complex. If a property is held for a **short term**, i.e. 12 months or less, any gain, for U.S. tax purposes, is taxed as ordinary income at the individual’s graduated marginal U.S. tax rate. The U.S. tax rate on **long-term** gains will depend on how long the property has been owned and on the individual’s tax bracket. Property held more than one year but not more than five years is subject to a capital gains tax rate of 20%¹¹ (or 10% for tax brackets lower than 25%). Gains arising on dispositions of property held for more than five years are taxed at 18%¹² (or 8% for tax brackets lower than 25%).

Under Canadian tax law, a taxpayer may exclude any gain that arises on the sale of the taxpayer’s “**principal residence**”, without limitation. Under current U.S. tax law, a taxpayer can exclude up to US\$250,000 (US\$500,000 for married couples filing joint U.S. returns) of any gain from the sale of their main home that is owned and used by the taxpayer as a principal residence for at least two of the five years prior to the sale. Gains in excess of the US\$250,000 (US\$500,000) are subject to tax in the U.S. at the capital gain rates indicated above.

¹⁰ Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (see discussion on Recent Changes in Legislation) the AMT exemption amounts are scheduled to increase for 2003 and 2004. This will cause AMT to arise at slightly higher income levels.

¹¹ Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (see discussion on Recent Changes in Legislation) the maximum tax rate on net capital gains is reduced from 20% to 15% (from 10% to 5% for the lower tax brackets) for dispositions after May 5, 2003 and before January 1, 2009. For 2008, the 5% rate is reduced to nil. After December 31, 2008, the 20% and 10% rates are to be reinstated.

¹² Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (see discussion on Recent Changes in Legislation) the 18% and 8% rates are repealed for dispositions after May 5, 2003 and before January 1, 2009. These gains will instead be taxed using the long term capital gains tax rates of 15% and 5%.

Also, pursuant to Canadian tax law, capital losses that exceed capital gains in a particular year can either be carried back and applied to offset capital gains earned in the previous three years or carried forward indefinitely to reduce future capital gains. Under U.S. tax law, however, to the extent capital losses exceed capital gains, up to an additional US\$3,000 of capital losses may be claimed against other income in the year. Any unused capital losses may be carried forward and applied against future capital gains or against US\$3,000 of other income in any future year (i.e. there is no provision to carry the loss back).

As the above discussion indicates, the Canadian and U.S. tax systems are not integrated with respect to capital gains; thus it is important for a taxpayer realizing capital gains to obtain professional advice to minimize potential double-tax.

v. Dividend income

As indicated, U.S. non-resident citizens are taxable in the U.S. on their worldwide income, including dividend receipts. The U.S. tax rate on certain dividends is being reduced. Specifically, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (see discussion on Recent Changes in Legislation below) reduces taxes on qualified dividend income received by an individual (i.e. a non-resident U.S. citizen) from U.S. domestic corporations, and from qualified foreign corporations, by taxing such dividends at the same 5% or 15% rates¹³ that apply under the Act to capital gains on assets held between one and five years. The reduced rates apply to dividends received from January 1, 2003 to December 31, 2008. Subject to future Treasury guidelines, it appears that Canadian corporations may be classified as qualified foreign corporations, eligible for the reduced tax rates.

vi. Canadian Retirement Plans (RRSP, RRIF, RPP or DPSP)

Although income earned within a retirement plan, such as an RRSP, RRIF, RPP or a DPSP, is *not* subject to Canadian tax until funds are actually withdrawn from these plans, there are no corresponding deferral provisions for this income under U.S. tax law. Thus, there can be a mismatching in the timing of income recognition in the two countries which could cause a double-tax situation.

The Canada/U.S. treaty provides some protection against double-tax. Specifically, an annual election can be made when filing the U.S. tax return to defer, for U.S. tax purposes, the recognition of income accrued in the retirement plan in the year until the funds are distributed from the plan.

Recently, the U.S. has changed its **reporting rules** regarding these plans.¹⁴ Under these new reporting requirements the obligation to report information to the IRS has become much more onerous, starting with the 2002 U.S. tax filings. Non-compliance could lead to penalties being assessed.

Specifically, [i] the trust (e.g. the RRSP) must file an annual information return (Form 3520A) and [ii] the taxpayer (beneficiary) must also file an annual return (Form 3520) reporting the activities of the trust. Failure by the taxpayer to report a contribution or withdrawal to these types of plans will result in a **penalty equal to 35% of the contribution or withdrawal**. Failure by the trust to file the annual information return will result in a **penalty equal to 5% of the plan's assets**.

¹³ See Footnote 11.

¹⁴ For U.S. tax purposes, foreign retirement plans are considered "grantor trusts."

The filing of these forms is onerous and the potential penalties are severe. The filings can be reduced if a taxpayer files a U.S. return and elects to defer recognition of the income accrued in the plan in the year. In this case, the obligation by the trust to file the 'annual information return' is eliminated, and the taxpayer only needs to file an activities form (Form 3520) if there has been a withdrawal from the plan in the year.

The new reporting requirements begin for the 2002 taxation year. However, for 2002, the IRS has extended the time to file the election and/or forms 3520 and 3520A to **August 15, 2003**, with the penalties to apply for non-compliance after August 15th.

vii. Recent Changes in Legislation

Like Canada, recent changes to U.S. tax law have been directed at reducing the tax burden on taxpayers, both individuals and corporations. Many of the changes are complex, and some are to apply on a temporary basis. The discussion below provides added information on the specific legislation.

On June 7, 2001 the **Economic Growth and Tax Relief Reconciliation Act of 2001** ("Economic Growth Act") came into law and introduced several significant **tax reduction measures** for individuals, including the following: [i] a gradual reduction in U.S. personal income tax rates, [ii] a reduction in, and the gradual repeal of, estate and generation-skipping transfer taxes, and [iii] a reduction in the gift tax.

However, the tax measures introduced in the Act are **not** permanent – they are scheduled to expire on December 31, 2010. Due to procedural obstacles in the Senate when the Act was introduced, a "sunset provision" was included in the Economic Growth Act, which repeals the measures introduced in the legislation effective January 1, 2011. Barring action by the U.S. Congress before this time, after December 31, 2010, the tax laws will revert to the pre-2001 provisions, as if the Economic Growth Act had never existed. This 'sunset' provision could lead to a flurry of activity by taxpayers attempting to access lower tax rates before 2011. It also introduces uncertainty to tax planning, as taxpayers may feel that legislation may be introduced to make the tax measures permanent.

On May 28, 2003, the **Jobs and Growth Tax Relief Reconciliation Act of 2003**¹⁵ ("Jobs and Growth Act") introduced additional tax cuts for both individuals and corporations, and accelerated the phase-in of various measures introduced in the Economic Growth Act of 2001. However, these measures are also only **temporary**. Some of the measures included in the Jobs and Growth Act will be in place for as little as two years while some will be in place for up to 10 years.

A detailed discussion of the various measures introduced in both of the above mentioned legislation is beyond the scope of this TaxTalk. Professional advice is recommended before effecting tax, estate and will planning transactions that may have cross border implications.

¹⁵ We understand that the Economic Growth and Tax Relief Reconciliation Act of 2001 and Jobs and Growth Tax Relief Reconciliation Act of 2003 have both been passed into law.

U.S. ESTATE TAX FOR CANADIAN RESIDENTS/ CITIZENS

Taxpayers who are Canadian residents and citizens who own property located in the U.S. can be subject to U.S. estate tax, even if they are not U.S. citizens. U.S. property subject to U.S. estate tax includes tangible personal property and real estate located in the U.S., stock of U.S. corporations (even if held in a Canadian brokerage account), and U.S. pensions and annuities. Funds held in U.S. bank accounts by Canadians are excluded from U.S. estate tax.

The estate tax is based on the **value of the assets at the time of death** less certain allowable credits. A Canadian is entitled to an **estate tax credit**¹⁶ equal to the estate tax payable on an estate valued at US\$1million¹⁷. This is the same credit that U.S. citizens and U.S. residents are allowed¹⁸. However, the estate tax credit for many Canadians is reduced – the credit must be prorated by the value of the Canadian decedent's U.S. estate (i.e. U.S. situated assets) over the value of the decedent's worldwide estate. The worldwide gross estate is determined under U.S. law and may include items such as insurance that are not normally included in a decedent's estate for Canadian tax purposes.

To illustrate the proration of the estate tax credit:

At the time of his death, the gross value of Mr. Taxpayer's worldwide estate was US\$15,000,000, including a condo in Florida valued at US\$1,000,000 and U.S. shares valued at US\$200,000. Mr. Taxpayer is a Canadian resident/citizen who has lived in Canada his entire life.

If Mr. Taxpayer dies in 2003, the exemption amount would be US\$80,000 ($US\$1,000,000 * 1,200,000 / 15,000,000$). The estate tax payable would be approximately US\$400,000. If he dies in 2009 [when the credit is scheduled to increase from \$1 million to \$3.5 million], the exemption amount would be US\$280,000 ($US\$3,500,000 * 1,200,000 / 15,000,000$) and the estate tax would be reduced accordingly to approximately US\$250,000, i.e. a reduction of approximately US\$150,000.

In general, Canadians are not subject to U.S. estate tax unless the value of their worldwide gross estate exceeds US\$1 million. However, if a U.S. property estate exceeds US\$1 million **and** if U.S. property represents a relatively small proportion of the total estate, the credit prorating mechanism can reduce the estate tax credit significantly, and cause a large U.S. estate tax liability, as illustrated in the example above.

U.S. estate tax can be *deferred* if property is left to the surviving spouse who is a U.S. citizen or to a qualified U.S. domestic trust (QDOT). A detailed discussion of planning in this area is beyond the scope of this TaxTalk.

¹⁶ The credit offsets estate tax that would otherwise be due, and therefore provides the same relief for all taxpayers, regardless of the size of their estate.

¹⁷ The basic estate tax credit of US\$13,000 (equivalent to estate tax on the first US\$60,000 of U.S. property) is increased for Canadians under the Canada-US. Tax Convention to \$345,800 (equivalent to estate tax on US\$1,000,000).

¹⁸ Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (see discussion on Recent Changes in Legislation) the exemption amount increased from US\$675,000 in 2001 to US\$1,000,000 in 2003 and will reach US\$3,500,000 in 2009. For 2010, the estate tax is repealed/eliminated. For 2011, the estate tax is to be reinstated and the exemption amount will be US\$675,000, i.e. back to the 2001 amount.

Canada does not have an estate tax, which, as indicated, is levied based on the **value** of the U.S.-based asset. Instead, Canada's tax system forces recognition of accrued gains on the death of a taxpayer, except with the exception of any transfer of assets on death to a spouse (or spousal trust) at their tax cost. If gains are recognized by the deceased taxpayer in their final Canadian tax return, then Canadian income tax may be incurred in respect of these gains. As such, for many taxpayers, the Canadian and U.S. tax systems are not co-ordinated on death, and double-tax could arise.

There is potential **relief from the double-tax**. Canadian tax law allows U.S. estate tax to be deducted from a deceased person's Canadian tax otherwise payable in certain circumstances. In some cases, relief from double-tax will be available, but in other cases it may not. As an example, a Canadian taxpayer may pay estate tax related to the value of the U.S. asset, but perhaps not have any Canadian tax related to the deemed disposal of the asset, either because there was no gain, or because the asset was transferred tax-deferred on death to the spouse (or spouse trust). In this case, there would be no credit in Canada allowed for U.S. estate tax paid in respect of the asset.

The Economic Growth Act (2001) introduced changes to the estate, gift and generation-skipping transfer taxes. For those interested in more details of these changes, a more detailed summary is included at the end of this TaxTalk.

CANADIAN CORPORATIONS DOING BUSINESS IN THE U.S.

In today's economic environment, more and more Canadian businesses are exploring opportunities to expand their operations into U.S. markets. Entering the U.S. markets may be as little as simply advertising on Web sites, or may be as complex as setting up a new U.S. corporation with U.S. production facilities. Regardless of the complexity of the business structure, Canadian businesses must not only be aware of U.S. business practices in general, they must also be aware of the various tax regimes in the U.S. including federal, state and local taxing authorities.

Outlining the factors which must be considered in determining how a Canadian corporation might structure its U.S. business operations is beyond the scope of this TaxTalk; however, there are some key aspects of U.S. federal and state tax laws which all Canadian corporations with connections in the U.S. should be aware of¹⁹.

Under the Canada – U.S. Tax Convention (Treaty), Canadian corporations are only subject to U.S. **federal** taxation (i.e. required to file a U.S. corporate return(s)) if the corporation maintains a "permanent establishment"²⁰ or fixed place of business in the U.S. A Canadian corporation, which limits its activities in the U.S. to merely solicitation and distribution, would generally **not** have a permanent establishment ('PE') and thus would not be subject to U.S. federal taxation.

Trap for the Unwary: A corporation which does not have a PE in the U.S. but is active in the U.S. should consider filing a 'nil' U.S. federal tax return to disclose its claim for treaty protection. If the protective return is not filed, the company could be taxed in the U.S. with potential penalty and interest charges.

¹⁹ There are over 6,000 different types of taxes in the U.S. with different thresholds, rates and exemptions.

²⁰ A permanent establishment includes an office, factory, branch, place of management, or other fixed place of business and the use of employees who regularly exercise authority to conclude contracts on behalf of their employer. Advertising activities, storing inventory in a U.S. warehouse, acting through an independent agent or using employees who do not exercise authority to conclude contracts do not create a permanent establishment.

It is important to realize that the individual U.S. states are **not** bound by the Canada-U.S. Treaty. A U.S. federal law²¹ prohibits the individual states from imposing **state income tax** on any out-of-state corporation whose only activity in the state is limited to the mere solicitation of orders that are sent outside the state for approval provided that the goods are shipped from outside the state by common carrier. However, this U.S. federal law only exempts a corporation from state income tax, not from other state taxes, e.g. sales taxes, gross receipts taxes, capital taxes, value-added taxes.

For Canadian companies with U.S. activities that go beyond mere solicitation, the concept known as “nexus” is important. Nexus refers to the degree of physical presence or activity that a corporation may carry on in the state before the corporation would be subject to state taxes.

Although each state sets its own nexus standards, in general, activities that go beyond the mere solicitation of orders and shipment of goods into the state by common carrier, in essence, having a physical presence in a state, will create state tax nexus. Activities that may create nexus include having an employee or independent representative in the state, owning or renting property in the state, storing inventory, delivering inventory in company-owned vehicles, providing installation or repair services in the state, providing in-state customer training and customer service, shipping or delivering goods by private transport, or licencing of intangibles for use in the state.

As state government coffers continue to diminish, many states are aggressively targeting out-of-state corporations as potential sources for additional tax revenues by asserting that the company has a nexus in the state, and thus is subject to tax(es) there. There are many ways that a state is able to gather information. In addition to information obtained during the audit of in-state corporations, there are information-sharing agreements between states and with the IRS, the U.S. Department of Treasury and U.S. Customs that aid the individual states in targeting out-of-state corporations.

Many times, the first step initiated by these states is to send a letter to the Canadian company asking for a form to be completed in respect of their connection to the state. These forms should not be ignored, as failure to respond on a timely basis will lead to the assessment of penalties. Professional advice should be sought so that the forms can be completed to accurately describe the activities of the company in the state.

Several states have amnesty or voluntary disclosure programs and actively encourage out-of-state corporations to come forward to file forms/returns to avoid penalties and interest, which may be assessed for non-compliance

* * * * *

With the ever-changing economic and technological advancements, cross-border transactions will continue to increase. When dealing cross border, the various taxation rules of the relevant U.S. and Canadian jurisdictions need to be reviewed. The jurisdictions to consider include the relevant province(s) and state(s). The increased complexity can be exponential, and it is critical that professional advice is obtained to ensure that the many ‘traps for the unwary’ can be planned for, and hopefully, avoided.

²¹ Public Law – S 86-272 - A corporation may be immune from **state income tax** if the corporation’s **only** connection with the state is the solicitation of sales of tangible personal property that are approved outside the state and are shipped from outside the state. This immunity is all-or-nothing in respect of state income tax. It does not provide immunity from state sales taxes, gross receipts taxes, capital taxes, or value-added taxes.

Economic Growth and Tax Relief Reconciliation Act of 2001

Changes to the Estate and Generation-Skipping Transfer Taxes (GSTT)

In the U.S., there is a gift tax that can apply to gifts made during one's lifetime. There is also an estate tax that can apply to the estate of a decedent. Certain amounts are exempt. Taxable gifts made during a person's lifetime and the estate at death are combined in determining the exempt amount[s] and the rate[s] of tax applicable to gifts made during lifetime and the estate on death.

Under the **Economic Growth and Tax Relief Reconciliation Act of 2001** ("Economic Growth Act"), beginning in 2002, the 5% estate tax surtax²² and the estate and gift tax rates in excess of 50 percent were repealed. At the same time, the unified credit exemption amount (for both estate and gift tax purposes) increased from \$675,000 to \$1 million²³ of value. The maximum estate and gift tax rates will continue to be reduced and the exemption will continue to increase as outlined in the following schedule.

Calendar Year	Estate & GSTT Exemption ²⁴	Maximum Estate & Gift Tax Rates
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007 & 2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	N/A – Tax fully repealed	Gift tax remains, equal to top individual income tax rate of 35%
2011	\$1,000,000	55%

The annual gift tax exclusion amount of US\$11,000 in 2003 is not affected by the changes introduced in the Economic Growth Act. The annual tax-free maximum for a gift to a spouse who is not a U.S. citizen is US\$110,000 for 2003.

The Economic Growth Act includes measures to gradually reduce the federal credit for state death taxes beginning in 2002 until 2005 when the credit is repealed and replaced by an unlimited deduction for the state death taxes actually paid.

Under the present rules, the **cost basis** of assets transferred to beneficiaries is generally "stepped-up" to the fair market value of the assets at the date of death. These rules will continue to apply until the estate and GSTT taxes are repealed in 2010. Under the Economic Growth Act, for estates and decedents dying after 2009, a hybrid system will be used to determine the cost basis of the inherited property **beginning in 2010**. The new system will be beneficial to most taxpayers. A detailed discussion of these new rules is beyond the scope of this TaxTalk.

²²For large estates, there was a 5% surtax, above the highest rate of 50% that essentially phased out the benefit of the graduated rates.

²³As indicated, the gift tax exemption increases by \$325,000 in 2002, i.e. from \$675,000 to \$1 million. However, this increase does not "free up" \$325,000 of tax-free gift room for everyone. The amounts of taxable gifts made in previous years may reduce the availability of the increased gift tax exemption room.

²⁴For 2001 to 2003, the GSTT exemption was/is \$1,060,000. Starting in 2004, the GSTT exemption is the same as the Estate tax exemption, i.e. \$1.5 million in 2004, etc. In 2011 and thereafter the GSTT exemption will revert back to the 2001 amount of \$1,060,000.

TABLE OF CONTENTS

U.S. INCOME TAX FILING REQUIREMENTS FOR CANADIAN RESIDENTS/CITIZENS..... 4

- i. U.S. Individual Taxpayer Identification Number (ITIN)..... 4
- ii. Canadians Working in the U.S..... 4
- iii. U.S. Rental Income..... 5
- iv. Gambling and Racing Winnings..... 5
- v. Capital Gains on Sales of U.S. Real Estate..... 6
- vi. Capital Gains on Sales of U.S. Investments 6
- vii. U.S. Social Security Benefits..... 6

U.S. INCOME TAX FILING REQUIREMENTS FOR U.S. CITIZENS LIVING IN CANADA 6

- i. Foreign Earned Income Exclusion..... 7
- ii. Foreign Tax Credit..... 7
- iii. Alternative Minimum Tax 8
- iv. Capital Gains and Capital Losses 8
- v. Dividend income..... 9
- vi. Canadian Retirement Plans (RRSP, RRIF, RPP or DPSP)..... 9
- vii. Recent Changes in Legislation 10

U.S. ESTATE TAX FOR CANADIAN RESIDENTS/ CITIZENS 11

CANADIAN CORPORATIONS DOING BUSINESS IN THE U.S. 12

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

Offices 10 Bay Street, Suite 900
 (Bay Street and Queen’s Quay)
 Toronto, Ontario M5J 2R8
 Phone: 416-362-0515
 Fax: 416-362-0539

8501 Mississauga Road, Suite 100
 (Steeles Avenue and Mississauga Road)
 Brampton, Ontario L6Y 5G8
 Phone: 905-451-4788
 Fax: 905-451-3299

TaxTalk is prepared by our Tax Group