BRUNTON'S

U.S. Taxletter

FOR CANADIANS

Covering U.S. Aspects of U.S. Citizens or U.S. Residents with Canadian Income or Assets, and Canadians with U.S. Income or Assets

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ADMINISTRATIVE/LEGISLATIVE/ JUDICIAL UPDATE

Tax Treaty Protocol

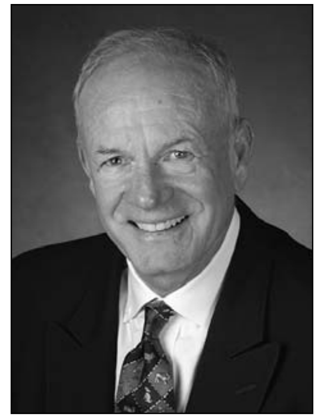
A public hearing on the 5th Protocol to the Canada-US tax treaty before the US Senate Foreign Relations Committee began on July 10th. After approval by the US Senate the "Instrument of Ratification" must be signed by the President and then each country must notify the other in writing that their procedures for ratification have been satisfied. Thereafter the terms of the Protocol will enter into force according to the time schedule agreed to in the Protocol.

Potential Canadian Interest Penalty for US Residents with Canadian Rental Income

Nonresidents of Canada who receive rental income from Canadian real estate are required to pay Canadian (Part XIII) tax of 25% of the gross rental income unless CRA Form NR6 is filed annually with the Canada Revenue Agency (CRA) and the rules thereof are complied with, including the appointment of a Canadian agent.

According to the Canadian Tax Court you cannot ignore this rule in situations where you intend to file a Section 216 Canadian income tax return that will show there was no profit. Interest will be payable to CRA on the amount of Part XIII tax that should have been paid even if the 216 return shows no profit. Interest will apply from the time the Part XIII tax should have been paid until the time the 216 return is filed showing no tax due. (Pechet, 2008 TCC 208).

Employer "E-Verify" Gains More Traction



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 37 YEARS.

All employers are legally required to verify the identity and employment eligibility of all *new* employees in the United States. To assist, the US Department of Homeland Security and the US Social Security Administration jointly operate a government program referred to as "E-Verify" that allows employers to electronically verify name, date of birth, and Social Security number, (along with immigration information for non-citizens), against federal databases in order to verify the identity and employment eligibility of both citizen and non-citizen new employees. Although it has been in effect for over 10 years, the use of the E-Verify system and its predecessor has been strictly voluntary on the part of employers.

However use of the system recently became mandatory for a small group of employers. The President has signed an executive order requiring companies that deal with the federal government to use the system to verify that their workers are in the country legally. A harbinger of things to come?

Florida to Change Payment Rules by 1 Day

Payments of Florida corporate estimated (installment) tax payments are generally due

by the 1st day of the fifth, seventh, and tenth months of the tax year and the 1st day of the first month of the following year. However effective January 1, 2009, each tax payment will be due ***before*** the 1st day of each of the above dates. Hopefully Florida will be reasonable about abating penalties next year while taxpayers become familiar with the new rules.

New Requirement for Pre-Screening of Visitors to the US

The US Department of Homeland Security has announced a new program, effective January 12, 2009, that will affect visitors traveling into the US from 27 "visa waiver" countries, including several Western European countries. The rule does not apply to residents of Canada, but perhaps it is another harbinger of things to come.

Under the new requirement, (known as the "Electronic System for Travel Authorization") these individuals will be required to provide the US with basic identification information at least three days before their arrival in the United States. This registration can be done online and will be good for two years unless the traveler's passport expires sooner.

It is expected this new requirement will inadvertently result in the temporary rejection of some individuals that would have had unquestioned entry under the present rules. Such individuals will then have to formally apply for a visa, which could substantially increase the number of visa applicants, and thus increase delays in the issuance of visas.

Tax Preparer Penalties

The US Internal Revenue Service (IRS) has issued proposed regulations on tax preparer penalties with respect to "positions" taken on a tax return. Among other matters, the proposed regulations attempt to clarify the "*more likely than not standard*" that applies to determine whether there must be a separate "disclosure" of a position taken on a tax return.

When the taxpayer has a "reasonable basis" for the tax return position, but the "more likely than not" standard is not met, disclosure must be made on the tax return. Otherwise preparer penalties apply. The proposed regulations provide guidance on what constitutes adequate disclosure. This can be done in one of five ways, including the use of the IRS form 8275. (NPRM REG-129243-07).

Meanwhile Congress is working on legislation that would make the above proposed regulation obsolete by requiring the preparer to have "substantial authority" for the position taken on a tax return to avoid a separate disclosure. (H.R. 6049, Section 321).

No Economic Stimulus Payments for Nonresident Aliens

In accordance with legislation passed by Congress, the IRS has been issuing "economic stimulus" payments to many individuals. To ensure all individuals entitled to the payments actually receive them, the IRS has mailed information letters to many individuals, including individuals who live outside the US and receive US Social Security payments. This has created some confusion as to who is actually eligible for the payments.

US citizens are entitled to the payments provided their income is not above the phase-out threshold. US residents (including green card holders living in Canada) are also entitled to the payments on the same basis, provided they are entitled to file, and do file, one of the "1040" versions of the US income tax return - e.g. Form 1040, Form 1040-EZ, or Form 1040-A.

Individuals who are nonresident aliens of the United States (i.e. individuals who must file one of the versions of US income tax Form 1040NR (e.g. 1040NR or 1040NR-EZ) are not eligible for the payments.

Florida Issues New Estate Tax Form

When a Canadian nonresident alien of the US dies owning US real estate it is normally necessary to get estate tax "clearance" before the property can be sold and the sales proceeds distributed. The related federal documents are the IRS "Estate Tax Closing Document" and the "Transfer Certificate". Depending on the estate tax rules in the particular State where the property is located, individual State estate tax clearance may also be required.

Florida Rules - Since 2005, Florida has not levied an estate tax. Nonetheless, the State has an estate tax procedure to be followed. The following rules apply for deaths of nonresident aliens after 2004 who owned Florida real estate.

1) If a US federal estate tax return is not required (generally only because the

decedent was a nonresident alien and the value of his/her "US property" did not exceed $60,000) the estate must file Florida Form DR-312 ("Affidavit of No Florida Estate Tax Due"). It is filed (recorded) in the county where the property is located. It is not filed with the State of Florida.

2) If a US federal estate tax return is required, the estate must file Florida Form DR-313 instead. As above, the form is recorded in the County records where the property is located, not with the State of Florida.

At the moment, a Florida Estate Tax Return is not required for deaths after 2004. However this may change. (FL Statute 198.13(4)(a)).

Also please see the article ***"FEDERAL LIENS FOR ESTATE AND GIFT TAXES"***.

Canadian Income Tax Act Section 119 Deadline?

Section 119 of the Canadian Income Tax Act provides for a potential refund of all or part of Canadian "departure tax" if the particular asset generating the departure tax is later sold for a loss. The amount of the refund is the lesser of two computations made under Section 119. It appears the Canada Revenue Agency may unofficially consider there to be a six-year deadline for claiming the refund. The six year test apparently starts from the date of the CRA Notice of Assessment for the tax year of departure.

US Goes to Court over Undeclared Accounts

In the last Taxletter we summarized circumstances where US persons (and potentially others) are required to file a "Report on Foreign Accounts" (IRS Form TD F 90-22.1). On June 30th the US Justice Department apparently sought a federal court order to force one foreign bank (UBS AG) to provide the names of wealthy US clients that held undeclared accounts.

Filing Extension Reduced to 5 Months

Effective January 1, 2009, newly issued IRS temporary regulations reduce from 6 months to 5 months, the automatic extension period for partnerships to file Form 1065, Income Tax return, or Form 8804, Annual Return for Partnership Withholding Tax, and estates and trusts to file Form 1041. As in the case of Florida deadline changes mentioned above, hopefully the IRS will be reasonable about abating penalties next year while taxpayers become familiar with the new rules.

US EXPATRIATIONS! - Will JUNE 17, 2008, BE "A DAY IN INFAMY"?

On June 17th the President signed new legislation referred to as "HEART" (Heroes Earnings Assistance and Relief Tax Act of 2008"). The legislation is primarily aimed at assisting US military personnel. However, purportedly to assist in complying with the legislation's requirement to be "revenue neutral", the legislation includes drastic new "expatriation" rules. We warned about this imminent legislation on page 2 of the Winter-Spring, 2008, issue of the Taxletter.

Generally, individuals who "expatriate" (i.e. US citizens who renounce US citizenship, and green card holders who are "Long-Term Residents" who relinquish their green cards), will subject to new US tax rules. Those who "expatriate", on or after June 17, 2008, will be deemed to have disposed of their worldwide assets at fair market value immediately before the expatriation and be subject to US tax on any hypothetical gain. The US refers to this as the "mark to market" rule, not a deemed disposition.

Many exceptions apply as set out below, and there will be an exemption from tax on the first $600,000 of gains. Simultaneous changes were made to the US gift and estate tax rules.

The new rules are implemented by:

1) the introduction of a completely new Internal Revenue Code Section 877A ("Tax Responsibilities of Expatriation"), and

2) the introduction of a completely new Chapter 15 in the Internal Revenue Code ("Gifts and Bequests From Expatriates") which contains the astonishing new Internal Revenue Code Section 2801. (Please see the separate article ***"NEW RULES FOR GIFTS & BEQUESTS FROM EXPATRIATES AFTER JUNE 16, 2008")***.

NEW SECTION 877A ("TAX RESPONSIBILITIES OF EXPATRIATION")

Imposition of Tax

Generally, the property of a "covered expatriate" will be treated as sold for fair market value on the day before the expatriation. The first $600,000 in gains (adjusted for inflation after 2007) will be excluded from tax. The term "covered expatriate" is similar to the previous expatriation legislation except for the rules for determining when an individual is no longer a United States citizen or a Long-Term Resident. The old rule (IRC 7701(n)) has been deleted from the tax code. The definition of "covered expatriate" is summarized again at the end of this article. The definition of "Long-Term Resident" remains unchanged from the prior law, but is also repeated below.

Deferral of Payment of The Tax

The taxpayer may elect to defer payment of the tax until the due date of the return for the year in which the property is actually sold, provided "adequate security" is provided to the IRS. "Adequate security" with respect to any property is defined as a bond that meets the requirements of Section 6325(b), and Reg. 400.2-1(b), a letter of credit, *or* other form of security to be set out in IRS regulations. However it appears interest will apply from the normal due date of the tax return for the year of expatriation. (IRC 877A(b)(7)).

Exclusions

The following general exceptions apply to this new ("mark to market") rule, including:

1) certain deferred compensation items such as individual retirement accounts, foreign pension plans, deferred compensation plans and, in certain cases, rights to receive property in connection with the performance of services, except to the extent the amount is attributable to service performed outside the United States while the individual was not a US citizen or US resident,

2) certain "specified tax deferred accounts" (See IRC 877A(e)(2)), and

3) any interest in a nongrantor trust. However the distribution of property from such a trust may trigger a taxable gain based on the fair market value of the property. (IRC 877A(f)(1)(B)).

Step-Up in Basis (Cost Base)

Somewhat similar to Canada's rules, when an individual (who is not a US citizen) becomes a resident of the United States the individual will receive a "step up" in the cost base of his/her assets, but only for future expatriation tax purposes. Please see the separate article ***"IMPORTANT NEW US TAX CONSIDERATIONS FOR NEW US RESIDENTS"***.

"Covered Expatriate" Defined

Of course the expatriation rules described above only apply to a "covered expatriate".

An "expatriate" is:

1) an individual who relinquishes US citizenship on or after June 17, 2008, (IRC 877A(g)(2). (The date an individual ceases to be a US citizen is determined in accordance with Sections 7701(a)(50)(A) and (B) and 877A(g) (4)), or

2) a "Long-Term Resident" of the US who, on or after June 17, 2008, ceases to be a lawful permanent resident of the US (i.e. officially surrenders the green card) and/or commences to be treated as a resident of a foreign country under the provisions (generally Article IV- Residence) of a tax treaty, does not waive the benefits of the treaty, and "notifies the (IRS) of the commencement of such treatment" - i.e. generally files a US income tax return claiming the benefits of the treaty. (IRC 877A(g)(2) and IRC 7701(b)(6)).

A "covered expatriate" is an expatriate (as defined above):

1) whose average annual net income for the period of five taxable years ending on the date before expatriation is greater than $124,000 (adjusted for inflation after 2004), ***or***

2) whose net worth at the date of expatriation was $2 million or more, ***or***

3) who fails to certify under penalty of perjury that his/her US tax obligations for the last five years have been met, or fails to submit evidence of such compliance as required by the IRS. (IRC 877A (g)(1)(A)).

Exceptions to "covered expatriate" - an individual will not be treated as meeting the requirements of paragraphs 1) or 2) immediately above if the individual became at birth a citizen of the US and another country and other requirements are met, or the individual's relinquishment of US citizenship occurs before age 18 1/2 and other requirements are met.

Long-Term Resident Defined

The definition of "Long-Term Resident" remains the same as before. A "Long-Term Resident" is any individual (other than a US citizen) who is a lawful permanent resident

United States in a least 8 taxable years during the period of 15 taxable years ending with the taxable year of expatriation. For this purpose, an individual will not be treated as a lawful permanent resident for any taxable year the individual is treated as a resident of a foreign country for the taxable year under the provisions of an income tax treaty, and does not waive the benefits of the treaty applicable to residents of the foreign country.

NEW RULES FOR GIFTS & BEQUESTS FROM EXPATRIATES AFTER JUNE 16, 2008

As part of the new "expatriation legislation" enacted June 17, 2008, an entirely new tax code Section (IRC 2801) applies to certain gifts and bequests. Generally, if a US citizen (resident anywhere) or a US resident, receives a "covered gift or bequest" from a "covered expatriate" there is US tax on the value of that gift at the highest tax rate provided in the tax rate schedules for US estate tax or gift tax (currently 45%). Exceptions are set out below.

For the definition of a "covered expatriate" please see the article ***"US EXPATRIATIONS! - Will JUNE 17, 2008, BE "A DAY IN INFAMY"?***

This tax is payable by the individual receiving the gift or bequest. Section 2801 does not define "resident" for this purpose and thus it is not fully clear whether the income tax or estate tax definition of resident applies. If the income tax definition of resident applies, (for example, the "substantial presence test"), it becomes even more important for many Canadian snowbirds and others who meet the substantial presence test to rigorously ensure they annually file IRS Form 8840 (Closer Connection Statement). Otherwise such snowbirds and others, for example, could potentially be subject to the 45% US tax on gifts or bequests received from certain other Canadians who previously expatriated from the US!

"Covered Gift or Bequest"

This new rule applies only to a "covered gift or bequest". A "covered gift or bequest" means:

1) property acquired by gift from an individual who, at the time of such gift, is a "covered expatriate", and

2) property acquired by reason of the death of an individual who, immediately before such death, was a "covered expatriate".

Exceptions

The normal annual exclusions apply -- currently $125,000 annually to a nonresident alien spouse, and $12,000 annually to other donees. Also the tax will not apply to property otherwise subject to gift tax or estate tax if a timely tax return is filed. Other exceptions apply to transfers to certain charitable organizations or US citizen spouses that would apply if the transferor were a US citizen. Special rules are included with respect to transfers to trusts.

The tax on any "covered gift or bequest" will be reduced by the amount of gift or estate tax (but apparently not income tax) paid to a foreign country on the gift or bequest.

CANADIAN PARTNERSHIPS OWNING US REAL ESTATE

Like Canada, the United States generally imposes a withholding tax at the time a non-resident or foreign entity sells domestic real estate. Of course in the case of the United States, US citizens are exempt from the withholding tax but not the actual tax. The US withholding tax ("FIRPTA withholding tax") is generally 10% of the selling price, although exemptions or reductions may apply.

Unusual FIRPTA withholding tax issues may arise when:

1) a Canadian sells a partnership interest in a Canadian partnership when the partnership owns US real estate, or

2) a Canadian partnership "distributes" it's US real estate to its partners.

Sale of US Real Estate by a Canadian Partnership

If a Canadian partnership sells US real estate the normal "FIRPTA" withholding tax rules apply, requiring a withholding of 10% of the selling price, unless an exemption or reduction applies. The withholding tax applies because a foreign partnership is considered a "foreign person" for purposes of the FIRPTA withholding tax rules. (Reg. 1.1445-2 (b)(2)(i), and Reg. 1.1445-5(b)(3)(ii)).

Sale of a Canadian Partnership Interest by a Canadian Nonresident Alien of the US

The sale of a partnership interest in a Canadian partnership by a Canadian nonresident alien of the US or Canadian corporation is subject to US withholding tax when 50% or more of the value of the partnership's gross assets constitute "US real property interests" and 90% or more of the value of the partnership's gross assets consist of "US real property interests" plus cash and cash equivalents. If this threshold is met, then the US 10% withholding tax is required on the full amount received by the selling foreign partner. (IRC 1445(e)(5) and Reg. 1.1445-11T).

The seller then files a US income tax return and "settles up" on the actual amount of US tax payable. On the income tax return the seller may demonstrate the extent to which the gain on the sale of the partnership interest is attributable to US real estate, in which case there may only be US tax on that portion of the gain.

Of course you ask……"how will the IRS know that a Canadian partner sold his/her interest in a Canadian partnership?" Although compliance enforcement by the IRS may seem difficult, the Canadian seller may be forced to comply if other people associated with the transaction are aware of their potential liability for the tax.

For example, the buyer of the partnership interest (including a Canadian) is primarily liable for the tax and therefore, if aware of the US rules, might be reluctant to conclude the purchase unless the withholding tax liability is addressed. In addition, any other person involved in handling the transaction might have a liability for the withholding tax.

Distributions by a Canadian Partnership

There does not appear to be a "FIRPTA" withholding tax requirement in effect with respect to the distribution of US real estate by a Canadian partnership to its partners. Tax code section 1445(e)(4)) imposes such withholding, but only after the issuance of related regulations by the IRS. So far the IRS has not issued related regulations and therefore there apparently is no withholding on such a distribution at the moment.

In any event, there is often no taxable transaction anyway when real estate alone is distributed to a partner, regardless of the residence of the partnership. Tax may arise however when cash is distributed to a partner in an amount that exceeds the partner's cost base.

Please see also the article ***"WHAT IS A PARTNERSHIP?"***.

US STATE SALES TAX & CANADIAN BUSINESSES WITH US SALES

Many Canadian businesses sell their product (or services) in the US. If you ignore the individual State sales tax requirements it may lead later to the assessment of significant penalties and interest as well as the tax itself. Readers are aware the terms "nexus" and "physical presence" are important factors in the evaluation of individual State tax requirements. For a State to levy sales tax, the seller must have "nexus" with the State. To have "nexus" with the State for sales tax purposes the seller must have a "physical presence" in the State.

Thus, for State sales tax purposes, "physical presence" is a sort of "stop loss test" (actually referred to as a "bright-line" test in the tax jargon). In other words, if you are certain you do not have a "physical presence" in a State you will not be exposed to sales tax in that State. The authority for this stems from two important US federal court decisions (National Bellas Hess Inc. v. Illinois Department of Revenue in 1967, 386 US 753, and Quill Corporation v. North Dakota in 1992, 504 US 298).

However determining whether you have a "physical presence" in a State may be problematic in many cases. For example, what is your status if you have an unrelated business in the State with offices or employees in the State, or independent agents acting for you in the State?

Following are the results of just a few court cases that might apply to your circumstances:

1) A mail-order seller in State A was subject to State B sales tax when the seller had retail locations in State B, (Nelson v. Montgomery Ward, 312 US 373).

2) A seller in State A was subject to State B sales tax when it had employees in State B taking and transmitting orders to, and for delivery from, State B. (General Trading Co. v. State Tax Commissioner 322 US 325).

3) A seller from State B was not subject to sales tax in State A when the seller's truck, based in State A, made only an occasional entrance into State B to deliver property to customers in State B. (Miller Brothers v. Maryland, 347 US 354).

4) A seller from State A was subject to State B sales tax because it had "nonemployee representatives" (independent brokers) in State B. (Scripto v. Carson, 362 US 207). In this case (Florida) the fact that the brokers, (who were Florida residents) were independent contractors, rather than employees, did not change the result.

5) A seller from State A was subject to sales tax in State B when another division of the seller had advertising sales offices in State B. (National Geographic v. SBE, 430 US 551).

Generally, an office or other place of business, the employment of individuals in the State, or property (including inventory) in the state, will constitute "physical presence".

Ownership of property in a state will not necessarily constitute "physical presence" if the property is insignificant. The retention of title to licensed software present in the State (the Quill case) and the presence of films rented to customers for previewing prior to a purchase (Cally Curtis Co. v. Groppo, 214 Conn 292) were found to be "de minimis" and did not constitute "physical presence".

If you are initially uncertain whether you have "physical presence" in a State, you may first wish to examine whether you would have a sales tax liability even if you do have a physical presence! For this you must examine the rules for the specific State involved.

For example there might be no State sales tax if:

1) the property or service itself is nontaxable according to State legislation. (Each State has a list of nontaxable goods and services).

2) the sales are at wholesale only and not subject to tax. (You may be required to register anyway and obtain an exemption certificate from your buyer and/or the State).

3) sales to the customer are not taxable. (For example, sales to a State government may not be taxable).

4) The property or service itself is nontaxable according to the U.S. Constitution.

5) The number of sales each year is not significant. (A State statute may prescribe the number of transactions which can be disregarded).

6) The activity is not significant. (For example, a State statute may address the issue of attendance at trade shows).

If you were uncertain whether you have "physical presence" in a State in which you make sales, and you have determined your transaction is not exempt from that State's sales tax, you must of course then go back and rigorously evaluate whether you do, in fact, have a "physical presence" in the State. This may involve reviewing State statutes, reviewing State court cases, and perhaps even speaking with the General Counsel's Office in the Revenue Department in that particular State. (Please see also the articles ***"US STATE SALES TAX AND COMPUTER/SOFTWARE ISSUES" and "MAIL ORDER SALES AND STATE SALES TAX")***.

US ESTATE AND GIFT TAX - LIABILITIES AND LIENS

The US tax code contains various sections addressing liabilities and liens for federal taxes.

Section 6321 generally provides that if any person neglects or refuses to pay any tax for which he/see is liable, the amount of the tax, penalty, and certain other costs will constitute a lien in favor of United States upon all of the property owned by the individual!

The lien imposed under section 6321 arises at the time the assessment is made and continues until the assessment is paid or "becomes unenforceable by reason of lapse of time". (IRC 6322). Such liens will not be valid against "purchase holders of security interest", "mechanic lienors" and "judgment lien creditors". (IRC 6323).

In addition, Code Section 6324 provides for special liens, specifically for estate and gift taxes.

Estate Tax

Liability - Estate tax is a tax on the estate of the decedent. However the tax is to be paid by the Executor. (IRC 2002). Hence the Executor has a responsibility ensure the Estate complies with its tax liability.

This may cause concern amongst knowledgeable Executors when there are unusual or questionable items associated with a US Estate Tax Return. For example, the existence of a Canadian life insurance policy and a decedent's Canadian pension that continues to the surviving spouse are matters that must be taken into consideration when applying the tax treaty to the US estate tax computation when a Canadian nonresident alien of the US dies while owning US property.

Also, if, in accordance with his/her US estate tax planning, the decedent placed a nonrecourse mortgage on the US real estate, or acquired the US real estate via a "purported" irrevocable trust, the knowledgeable Executor will want to ensure those documents will withstand scrutiny as such, if the estate tax return is audited by the IRS.

Liens and Liability - Unless the required estate tax is paid (or becomes "unenforceable by reason of lapse of time") it becomes a lien upon the gross estate (world wide assets) of the decedent for 10 years from the date of death. (IRC 6324(a)).

Also, if the estate tax is not paid when due, the person who acquires the property from the decedent (the "heir"), including a joint owner of the property, is personally liable for the tax. Thus, although the lien may disappear after 10 years, the personal liability of the "heir" is not extinguished.

If the property is sold by an "heir", the lien is removed from that property, however a lien is then attached to all of the property of that heir! (IRC 6324(a)(2)).

In addition, the Executor or "Personal Representative" of the Estate located in Canada may have personal liability for the estate tax under the interaction of Code Section IRC 2002 (mentioned above) and Section 2203. Where there is no Executor or administrator "appointed in the United States", the term "Executor" means "*any person in actual or constructive possession of any property of the decedent*". (IRC 2203). Thus, for example, certain individuals in Canada involved with administration of the estate may have personal liability for the US estate tax. These individuals are referred to as "statutory executors".

Statutory executors can protect themselves against possible liability for US estate tax by obtaining "transfer certificates" from the IRS. These are releases of the federal estate tax lien on a decedent's property. They are provided for under Section 6325 and Reg. 20.6325-1.

Gift Tax

Readers are aware the United States levies gift tax when a nonresident alien gives US real estate to another individual. Certain exemptions and exclusions apply.

Unless the gift tax is paid (or becomes unenforceable by reason of lapse of time) the tax generally becomes a lien on all gifts made by the donor that year for 10 years from the date the gift was made. (IRC 6324(b)). Also the "donee" (the person receiving the gift) is personally liable for the gift tax to the extent of the value of the gift. If the donee transfers the property to a purchaser, the lien on that property is removed, but then the lien will generally attach to all of the property (including after-acquired property) of the donee! Therefore, although the lien on the original gifted property may disappear after 10 years, the personal liability of the "donee" remains.

An example may occur if mom and dad (Canadian nonresident aliens of the US) give US real estate to their son (a Canadian nonresident alien). If the appropriate gift tax is not paid, and the son ultimately sells the real estate, a lien may be attached to all of the son's assets to the extent of the value of the original gift (perhaps including interest and penalties).

BEWARE GIVING YOUR MORTGAGOR (BUYER) A "BREAK"!

Occasionally a Canadian will sell his/her US real estate and take back a mortgage from the buyer for a portion of the selling price. Canada and the US both have provisions to defer payment of a portion of the seller's income tax on gain on the sale so that it is due somewhat proportionately with the receipt of principal payments on the mortgage provided to the buyer.

In the US, the reporting of the gain, and payment of the tax is generally spread throughout the term of the mortgage (and payment of the principal) regardless of the length of the mortgage. It is not restricted to a five-year period.

But what is the status of this deferred taxable gain if the terms of the mortgage are changed? Is tax on the deferred gain immediately payable?

Because of the depressed real estate market in many areas of the United States, many lenders are finding it necessary to modify the terms of the mortgage they hold from such buyers, either by extending the due date, reducing the interest, deferring principal payments, or some other means.

Unfortunately, it is clear that ***if*** the mortgage (and related promissory note) are sold or otherwise disposed of by the holder, then US tax on all of the deferred gain is immediately triggered on the holder. (IRC 453). Also, under US rules, gain is triggered when there is an exchange of property for other property "differing materially in kind". (Reg. 1.1001-1(a)). Reg. 1.1001-3 provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Reg. 1.1001-1(a).

The regulations provide that an exchange occurs if there is "a significant modification of a debt instrument ". Regs. 1.1001-3(e) and (f) define "significant modifications". The guidelines get very specific, for example even describing the degree of change in the interest rate on the mortgage required to constitute a "significant modification".

However, absent any written or oral agreement to alter terms of the debt, an agreement by the holder to temporarily waive a default by the buyer ("temporary forbearance") is not a "significant modification" unless it remains in effect for a period that exceeds:

1) two years, and

2) any additional period during which the parties conduct good faith negotiations. (Reg. 1.1001-3(c)(4) ii)).

IMPORTANT NEW US TAX CONSIDERATIONS FOR NEW US RESIDENTS

The article ***"EXPATRIATIONS - Will JUNE 17, 2008, BE "A DAY IN INFAMY"?"*** referred to the new "step-up in basis" rules contained in the new US "expatriation" tax legislation enacted June 17, 2008.

In US tax jargon the terms "adjusted basis" or "basis" are similar to the term "adjusted cost base" used in Canada. The term "step-up in basis" refers to the increase in basis triggered under the tax code because of some taxable event. For example, when an individual dies owning US real estate, an individual inheriting the real estate may acquire a "basis" in the inherited property equal to the fair market value of the real estate, rather than acquiring a "basis" equal to the decedent's "basis".

The new expatriation legislation, effective June 17, 2008, provides that for purposes of the expatriation rules only (i.e. Section 877A only), property which is held by an nonresident alien on the date the individual first becomes a resident of the United States (as defined in code section 7701(b)) will be treated as having a basis on that date of not less than the fair market value of the property on that date. This step-up in basis applies only if the individual is later subject to the expatriation rules. Alternatively the individual can make an irrevocable election not to have this rule apply. (IRC 877A(h)(2).

The tax treaty also has potential step-up provisions.

Importance of Keeping Records

In view of this new rule, any nonresident alien who becomes a US resident (as defined under the US tax laws, not the US immigration laws) after June 16, 2008, should make a list of his/her worldwide assets at the date of becoming a US resident and should document the value of those assets at the date US residency is acquired.

For example, Statements from brokerage accounts, financial statements of private corporations, real estate tax assessments, and other similar documents indicating valuations at the date of acquiring residency should be retained.

Since real estate tax assessments are often not representative of the actual value of the real estate, consideration should be given in many cases to acquiring appraisals of the property, or at a minimum having a Realtor provide you with real estate "comparables" and perhaps an "Opinion of Value".

REVIEW OF US SOURCE RULES FOR CROSS-BORDER TAXATION

Rules are required to determine which country gets the first chance to levy tax when a resident of one country earns income that is also taxed in another country. Generally, the country in which the income is "sourced" gets the first chance to tax, and the other country allows the taxpayer a "foreign tax credit". Of course many exceptions apply and the tax treaty can override the domestic rules.

Most of the US domestic rules for sourcing income are contained in Code Section 861. Ignoring treaty overrides, they can be summarized as follows:

Interest - General Rule - the source of interest income is generally the residence of the obligor/debtor. A corporation incorporated in the US is considered resident in the US. A partnership (domestic or foreign) generally is considered to be resident of the US for sources of interest income purposes if it is engaged in business in the United States at any time during the year. (Reg. 1.861-2(a)(2)). An exception may apply to a foreign partnership that is predominantly engaged in business outside the US. (IRC 861(a)(1)(C)).

Exceptions to the general rule apply, for example:

a) in the case of a US resident alien or domestic corporation if such individual or corporation meets the "80% foreign business" requirements",

b) when a foreign corporation engaged in US business (or having income treated as effectively connected with US business) pays interest from its US branch, the interest may be treated as if it were paid by a domestic corporation. (IRC 884(f)(1)(A)), or

c) When "allocable" interest of the US branch of a foreign corporation (see Reg. 1-882-5) exceeds the interest paid, it can be considered as if it were paid to a foreign corporation by a domestic subsidiary. (IRC 884(f)(1)(B)).

Even if interest is "US source", depending on the circumstances there still may be no US tax -- for example, certain bank interest (IRC 871(i)) and "portfolio of interest" (IRC 871(h)) are exempt from US tax when received by certain nonresident aliens. Also, once the 5th Protocol to the tax treaty enters into force there will be no US withholding tax at source on any "arms length" interest.

Dividends - the source of dividend income is generally the place of incorporation of the payer. Exceptions may apply.

Dividends paid by a foreign corporation from US earnings may, in certain cases, constitute US source income. (See IRC 861(a)(2)(B)). Nevertheless, the dividends paid by a foreign corporation are not subject to US withholding tax at source pursuant to Code Section 871(i)(2)(D).

A portion of a dividend paid by a domestic corporation, although considered US source income, is not subject to US withholding tax at source if at least 80% of its worldwide gross income is "active foreign business income" for the three-year (or shorter applicable) period ending with the taxable year preceding the year of dividend declaration.

Performance of Services - income from services that are performed by self- employed individuals, and by entities, are usually apportioned between the US and foreign countries on the basis of the time work was performed in each country. (Reg. 1.861-4)(b)(1)).

Services performed by an employee are apportioned between countries in one of two ways depending on whether the compensation represents income other than "fringe benefits" or income from "fringe benefits". Income other than from fringe benefits is normally apportioned on the basis of time. Fringe benefits (housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursement) are normally allocated based on the taxpayer's principal place of work. (Reg. 1.861-4(b)(2)).

Proposed regulations address the source rules for compensation paid to artists and athletes. In this case, the compensation would be allocated on a new "events basis". (Prop Reg. 1.861-4(b)(2)(ii)(G)). See examples 7 through 10 in the proposed regulations. Example 8 indicates a musical group would allocate its contract income from a tour of more than one country on the basis of income from each country, not the time spent performing in each country. Example 10 describes circumstances in which a member of a sports team would allocate his regular compensation on the time basis, but would allocate any additional amounts received for playing in preseason and postseason games under the event basis method - i.e based on the location where each preseason or postseason game was played.

In the case of flight personnel and seamen, the apportionment of income from international flights or voyages between the United States and a foreign country may be made under the normal "time spent" apportionment rule. In the case of a US citizen "time spent" includes preflight services performed in the United States.

Reimbursed moving expenses paid by a new employer, or by a continuing employer if the reimbursement is conditioned upon the performance of future services, generally is sourced where the future services are to be performed. Moving expenses reimbursed by a former employer, or even by a continuing employer if the agreement to reimburse expenses is not contingent on continued employment, are sourced where the services were rendered to the former employer. (Regs. 1.911-3(e)5)(i)).

Treaty Override

If you are claiming foreign tax credits under Article XXIV of the tax treaty, the source rules under Article XXIV(3) will apply. That Article overrides the foregoing, where applicable, and provides, generally (for purpose of that Article only) that:

1) Profits, income, or gains of a resident of one country which can be taxed in the other country shall be sourced in the other country. (An exception applies for gains described in Article XIII(5)), and

2) Profits, income, or gains of a resident of one country which may not be taxed in the other country shall be sourced in the country of residence.

However it is not necessary for a US citizen or resident to claim foreign tax credits under Article XXIV. They can be claimed instead under the general rules of the Internal Revenue Code, in which case the source rules of the treaty do not apply.

US ESTATE TAX STATUS OF CERTAIN PROPERTY FOR NONRESIDENT ALIENS

The general rule is that "US property" is subject to US estate tax when owned by a decedent nonresident alien. But it is often unclear whether certain property is "US property", (i.e. has a "US situs"), or whether an exemption from estate tax otherwise applies. Some examples are summarized below.

Interest in a Trust

The IRS will generally "look through" a trust to determine its underlying assets. If the trust owns "US property", that portion of the trust principal will be subject to US estate tax for nonresident aliens to the extent of the decedent's interest in the trust. This will usually include Canadian Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs). Note however that some "trusts" are not really trusts under the US tax code definition of a trust. If there is an active business being conducted in the trust the IRS might classify it as a corporation instead of a trust.

Interest in a Partnership

Partnerships are perhaps the most difficult of all to express a general rule. In evaluating the estate taxation of a partnership interest (or the partnership's underlying assets) the IRS first looks to where the partnership is conducting its principal activities. If the principal activities were in the United States the partnership interest itself will be taxable as part of the nonresident alien's gross estate situated in the US.

Alternatively, if the decedent had an interest in a partnership that terminated upon death, pursuant to the law governing its operations, the decedent's share of the US assets of the partnership will be taxable.

In addition, according to the IRS position, any interest in a foreign partnership whose major asset is US real estate is "US property". (At least one US international estate tax attorney disagrees with this IRS position. It has apparently never been tested in court).

American Depository Receipts

Foreign stocks held as American Depositary Receipts (ADRs) are not subject to US estate tax. Their situs depends on the country of incorporation of the underlying security.

Mutual Funds

The taxation of a mutual fund investment depends on the legal organization of the fund (i.e. is it a trust, partnership, or corporation), and where it is resident.

If it is a trust or partnership the above rules would generally apply. If it is a foreign corporation it would generally not be subject to US estate tax for nonresident aliens. For the deaths in 2005, 2006, and 2007, the shares of a mutual fund that is a US corporation are exempt to the extent that the underlying assets of the mutual fund would be exempt. (IRC 2105(d)).

Annuities and Pensions

Annuities and pensions payable by US companies and other US entities are "US property" (US "situs") and therefore subject to US estate tax.

A DEMOCRATIC CONGRESS & CAPITAL GAINS TAX INCREASE?

There is much speculation that the Democratic party will do well in the US federal elections in November, and that it could lead to increases in US taxes. The US Internal Revenue Code is already complicated. For example our "hard copy" version of Section 1, (the Section that simply sets out the basic rate of income tax on individuals, trusts and estates) is about 35 pages long when you include all pages listing amendments and "sunset" provisions. Our entire "hard copy" version of the Internal Revenue Code is over 5,000 pages when you include all pages listing amendments and "sunset" provisions.

"Sunset" Provisions and Tax Increases

Partly to improve the "fiscal appearance" of the US federal budget, many tax reductions that were legislated in the past are scheduled to expire ("sunset") from time to time. For example, readers are aware that US estate tax is scheduled to completely disappear for the year 2010 and it is unclear what the law will be for 2011. This uncertainty is based on the fact that the current legislation "sunsets" (expires) after December 31, 2010. Absent new legislation before then, the law reverts in 2011 to the legislation in effect before the current legislation existed! However this is unlikely to happen. There are presently four sets of legislation before the US Congress to address estate tax, all of which continue the tax after 2009.

Capital Gains Tax - perhaps of particular concern to Canadians that are nonresident aliens of the US will be the US capital gains tax rate on their real estate sales in the future. The US presently has an "advertised" maximum tax rate of 15% on long-term capital gains of real estate. However this "advertised" tax rate is somewhat misleading since alternative minimum tax may apply and certain recaptured depreciation can be taxed at 25%.

Also, perhaps mainly relevant for US citizens and US residents, although the capital gain on a real estate sale may be taxed at a maximum of 15%, the real estate gain, when added to the other income of the individual for the year, can elevate the other income into a higher US tax rate bracket than would otherwise apply.

In any event, the present maximum 15% tax rate on long-term capital gains "sunsets" for sales after December 31, 2010. Thus, it is possible (likely?) that the long-term capital gains tax rate on real estate sales will increase in the next few years regardless of which political party controls Congress and the Presidency after November, 2008.

CANADIAN PENSION SPLITTING & CROSS-BORDER MARRIAGES

Certain married residents of Canada can split their Canadian pension income between spouses on their Canadian income tax returns, thus potentially reducing the Canadian income tax of the "high income" spouse more than the tax increase to the other spouse.

However suppose the high income spouse is a US citizen and the other spouse is a nonresident alien of the US. Under the US "assignment of income principle" the high income spouse would not be able to reduce the income on his/her separate US income tax return by the amount of pension allocated to the other spouse on the Canadian income tax return.

Accordingly the high income spouse would pay US tax on the total gross (pre-split) pension but would only be able to claim a foreign tax credit in the US for the amount of Canadian tax actually paid by that spouse. Depending on the circumstances double tax could result.

Of course the spouses can file a joint return in the United States which might eliminate any negative tax results in the current year. However if the spouses elect to file such a joint return it continues in effect for all future years unless revoked by the spouses. If revoked they cannot make such an election again. (Reg. 1.6013-6(a)).

Therefore, before arbitrarily making the Canadian pension splitting election, such couples may wish to test the aggregate Canadian and US consequences of the election.

CAUGHT IN THE ACT

By former IRS attorney Robert S. Blumenfeld, Esq., tel. 954-384-4060, or email rblumenf@aol.com.

"*You have the right to remain silent…*"

What constitutes tax fraud? If an armed IRS agent appears at your door and pulls out a small white card and reads you the words quoted above, you could be in major trouble. Do not speak to this person! Get his business card and tell him that he will hear from your attorney.

How do you get into the crosshairs of the Internal Revenue Service Criminal Investigation Division ("CID")? Certainly most of us make minor errors on our tax returns. Also, the tax code has become so convoluted that even experts, and in many cases, IRS agents, cannot agree on what a correct result is. A misinterpretation of some obscure law, or even sheer stupidity in many cases, will not generally result in the involvement of the IRS criminal division.

Thus the critical distinction which one must keep in mind is the difference between tax avoidance and tax evasion. In the former case, one avoids or reduces tax liability through proper use of structures or vehicles sanctioned by the Internal Revenue Code. In the latter case, one attempts to escape the assessment or payment of a tax through methods that violate the Internal Revenue Code. The key difference between the two is "scienter", which means having requisite knowledge of wrongness, or the illegality of an act or conduct when one commits that act. In a criminal case, there is an element of liability or guilt which the prosecution must prove before one can be found guilty of criminal activity.

Normally, after a taxpayer files a tax return, an IRS computer reviews each return for possibilities of incorrectness, and if a certain "DIF" score is attained, the case is sent to a local IRS office for examination. There, a Revenue Agent examines the return. If minor errors, are found, he/she generally suggests an adjustment and closes the case. If there are substantial errors, the Revenue Agent must decide whether the taxpayer acted with scienter in preparing the return. The Agent has three options; close the case with the adjustments, close the case but recommend financial penalties, or send the case to CID for potential criminal prosecution.

Because of the number of returns that are found to contain errors, the criminal investigation division has created a bright line which must be crossed by the taxpayer before the case will be accepted for investigation. If, looking at tax returns encompassing three years, there are repetitive "similar" errors with a tax liability exceeding $70,000, the case falls within the parameters of CID. The bulk of the cases investigated do not warrant criminal prosecution, and are returned to the Revenue Agent for closure. A few returns, however, end up at the Department of Justice for criminal prosecution.

Recently, in testifying as an expert witness, I came upon a situation that could be criminally prosecuted by the IRS. The defendant, the owner of a corporation, diverted $89,500 from the corporate income by calling it a "consulting fee". He paid this to himself, but did not report it as income. Instead, he placed most of this money in another corporation he owned, but called it a "loan" instead of income. Thus he attempted to escape taxation on the bulk of this $89,500. Another shareholder discovered this problem and brought suit against the owner of the corporation.

If this happened in repetitive years and resulted in the saving of more than $70,000 in tax, the owner of the company could find himself in the presence of a CID agent whose first words would be, "you have the right remained silent…"

Robert Blumenfeld spent 32 years as a senior attorney with the Internal Revenue Service, most of it in Washington, DC. He can be reached at 954-384-4060 or rblumenf@aol.com.

STATE "SALES TAX" AND COMPUTER/SOFTWARE ISSUES

Canadian businesses selling products, or performing services, in the United States must comply with State sales tax requirements in the individual States. Each State has separate rules that differ from rules in other States. Many exemptions apply - in some cases you must register to claim the exemption and in other cases registration for the exemption is not necessary. Further, individual counties and even cities, may levy their own sales tax. Of course, you must have "nexus" in the individual State before you are subject to sales tax in that State. However very minimal presence in a State will often constitute "nexus" for purposes of sales tax in that State.

Most states provide information on their website with regard to products and services that are taxable and those that are exempt. Some of the most confusing rules apply with regard to "services". One example pertains to the provision of computer software, its installation, and the training you provide to the purchaser.

Sales and Installation of Computer Software

As indicated above, the rules vary from State to State. To give an example we will describe the rules for New York State.

Software Sales. In New York, the sale of "prewritten computer software" is generally subject to sales tax because it is considered "tangible property". (N. Y. Tax Law 1101(b)((6)). "Prewritten computer software" is computer software that is ***not*** software designed and developed by the author or creator to the specifications of a specific purchaser. (N. Y. Tax Law 1101(b)(14).

There is no specific exemption for "custom software". Therefore to ensure you obtain an exemption for "custom software" you must be able to document that your software does not fall within the definition of "prewritten computer software".

Installation and Training of Computer Software. New York sales tax is generally imposed on receipts from installing tangible personal property. (N.Y. Tax Law 1105(c)(3). However services in connection with software (regardless of whether the software itself is taxable or nontaxable) are exempt from tax. N.Y. Tax Law 1105(o). Therefore, for example, in New York a contract for the sale, installation, and training of computer software should state separately the charges for each service to ensure only the cost of the software itself is taxable, and not its installation and related training.

Note however that services in connection with computer *hardware* are generally subject to sales tax.

Please review the rules for the particular State with which you are involved before taking any action.

Also, please see the articles ***"US STATE SALES TAX & CANADIAN BUSINESSES WITH US SALES", and "MAIL ORDER SALES AND STATE SALES TAX"***.

THE DANGER OF HAVING A US AGENT

The US tax ramifications of having a "US agent" can be very complex because the analysis and results depend, among other things, upon:

1) whether the issue about which you are concerned is US federal tax, or tax in an individual State,

2) whether the agent is a dependent agent or independent agent,

3) in the case of individual State tax, whether the issue is income tax, franchise tax, or sales tax, and

4) in the case of federal tax, whether the tax treaty (the "permanent establishment" provision) applies.

Federal Rules

The first step in evaluating whether a Canadian business has US federal tax filing obligations (and perhaps even a federal tax liability) is to determine whether your Canadian enterprise is "engaged in a trade or business in the United States" ("ETB"). There is no precise definition of being ETB, however the court cases have suggested it means the US activity must be "regular, continuous, and considerable". For this purpose, what is the effect of having a US agent? Will the activities of the agent be attributed to you?

Agent Acting Exclusively for You. Generally, employees and "dependent" agents (agents acting exclusively or almost exclusively for their principal, or agents over which the principal has considerable control) will have their activities attributed to their principal. (See Lewenhaupt v. Commissioner 20 TC 151 (1953)).

Regularity of Activity. Activities of independent agents may in some cases be attributed to the principal if there is some regularity to the relationship. For example see Revenue Ruling 55-617 and Handfield v. Commissioner 23 TC 633 (1955). It is apparently unclear how "regular" the activities must be.

However the regular activities of an independent agent might not be attributed to the principal if the agent does not have the right to commit to any particular customer. (See Commissioner v. Piedras Negras Broadcasting 43 BTA 297 (1941)).

Agent Having Exclusive Rights. If an independent agent (commission agent) has exclusive rights to sell your product it is likely the agent's activities will be attributed to you. (See Revenue Ruling 76-161). Of course there is no "agency" relationship if the products are purchased from you for resale.

In that case there is a purchaser-seller relationship, not a principal-agent relationship.

Tax Treaty Rules

The tax treaty does not have any effect on whether your Canadian business is "engaged in US business". Of course in the case of a Canadian resident business, the activities of a US agent may not give rise to a "permanent establishment" (PE) in the US, under treaty Articles V(5), and V(7). However that Article in the treaty does not have a bearing on whether the Canadian business is "engaged in US business". That Article only has the capacity to exempt you from US income tax in cases where you *are* "engaged in US business". The possession of a US agent (dependent or independent) may therefore necessitate a US tax filing to claim the exemption under the treaty, and avoid the US penalty for failure to disclose the treaty position.

TIME FOR US CITIZENS & US RESIDENTS TO SELL THEIR CANADIAN CORPORATIONS?

We previously summarized the rules under Section 951 of the US tax code whereby US citizens and residents (including green card holders living in Canada) are potentially subject to US income tax on certain income earned inside their private Canadian corporations when it is not distributed to them. (Please see page 12 of the Summer, 2006, Taxletter and page 9 of the Winter-Spring, 2008 Taxletter).

Another section of the tax code contains a different rule that could affect you negatively on the sale of the corporation. If you "own" 10 percent or more of the combined voting power of a non-US corporation at any time during the 5-year period ending on the date of the sale (or liquidation) when the corporation was a "controlled foreign corporation" ("CFC") then the "gain" on the sale of shares may be treated as a dividend instead of a capital gain. (IRC 1248(a)).

However:

1) Under present law, you would generally be entitled to the 15% maximum rate on dividends if the corporation is a CFC, and a qualified resident of Canada under the treaty's Limitation on Benefits Article, at the date of sale,

2) Any amount previously taxed under Section 951 would be excluded from tax,

3) The amount taxed as a dividend would be limited to the amount of earnings and profits accumulated while a CFC, and

4) For individuals, the tax is limited to ensure you are not subjected to more tax than would have been the case if the corporation had been a domestic corporation. Thus the tax imposed by Section 1248(a) is limited to the sum of:

a) the excess of the US corporate tax that would have been payable if the corporation had been a domestic corporation, plus

b) the capital gain tax that would have been payable thereafter on the sale by the shareholder. (IRC 1248(b)).

Therefore at the moment this combination of factors may not result in significant US income tax on the sale of such a Canadian business. Although note that if there is Canadian tax on the sale, the US foreign tax credit rules may limit the US tax credit thus increasing the effective US tax rate above the 15% rate.

Perhaps more important, is the possibility that the US tax rate on dividends (see 1) above) will be substantially increased after the US elections in November. Please see the article ***"A DEMOCRATIC CONGRESS & CAPITAL GAINS TAX INCREASE"?***

WHAT IS A "PARTNERSHIP"?

The term "partnership" may mean different things to different people. Also it may actually have different definitions, depending on the context to which it applies. For example, in the business law context a business group joining together might constitute a "joint venture" but not a "partnership".

However for US federal income tax law purposes, a separate set of rules applies. For federal income tax purposes a "partnership" generally includes a group, joint venture, pool, syndicate, or other unincorporated organization through which any business, financial operation, or joint venture is carried on, (by two or more parties), and which is not a corporation, trust or estate. (IRC 7701(a)(2)).

A partnership under federal tax rules does not necessarily have to be a separate entity under state law and vice versa. "*Whether an organization is an entity separate from its owners (emphasis added) for federal tax* *purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law*" (Reg. 301.7701-1(a)(1)).

Whether an economic arrangement is a "partnership" (a separate entity) for federal tax purposes depends on whether the parties in good faith and acting with a business purpose intend to join together in the conduct of the enterprise. (Commissioner v. Culbertson 337 US 733). Then, in turn, the economic arrangement must actually rise to the level of a joint business activity. Of course it is not a "partnership" if it is more properly classified as a corporation or trust.

Thus a partnership can be distinguished from co-ownership (sometimes referred to as co-tenancy), and "expense sharing arrangements".

Factors indicating whether the parties intend to form a partnership may include:

1) The parties representing themselves to be joint venturers,

2) The parties keeping a separate set of books for the venture,

3) The conduct of business in the joint names of the parties, and

4) The agreement between the parties and the parties' control over income, capital, and the right to distributions.

Joint Owners of Rental Real Estate

In the rental real estate context, a question can arise whether a "partnership" exists or whether there is simply a "joint ownership". A separate entity (a partnership for tax purposes) may exist for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless a joint undertaking merely to share expenses does not create a separate entity (partnership) for federal tax purposes. (Reg. 310.7701-1(2)).

Of course one significance of the difference between a "partnership" and "joint ownership" is the fact that a partnership must file an income tax return, as well as the partners. In addition, there may be tax implications to a distribution of cash from the partnership to a partner. Also, please see the article "***CANADIAN PARTNERSHIPS OWNING US REAL ESTATE***".

MAIL ORDER SALES AND STATE "SALES TAX"

Although "physical presence" is necessary for a State to levy State sales tax on an out-of-state seller, the determination of whether "physical presence" exits in some situations can be problematic. A good example is "mail order sales".

Some States have enacted statutes to clarify the rules on when that State will require an out-of-state seller to collect sales tax on mail order sales to customers in that State.

For example, among other circumstances, Florida requires such tax to be collected if:

1) The property was delivered in Florida in fulfillment of a sales contract entered into in Florida when a person in Florida accepted an offer by ordering the property,

2) The seller owns real or tangible personal property that is physically present in Florida, (except in certain cases where the seller's only property in Florida is located at the premises of a printer),

3) The seller, while not having nexus in Florida itself, is a corporation that is a member of an "affiliated group", and another member of the affiliated group has nexus in Florida,

4) The seller maintains retail establishments or offices in Florida, regardless of whether the mail-order sales are related to those establishments or offices,

5) The seller, by purposefully or systematically exploiting the market provided by Florida by any media-assisted, media-facilitated, or media-solicited means, including, but not limited to direct mail advertising, unsolicited distribution catalog, computer-assisted shopping, television, radio, or other electronic media, or magazine or newspaper advertisements or other media, creates nexus with Florida, or

6) The seller is:

a) A corporation doing business under the laws of Florida, or

b) a resident of Florida,

(See Florida Statute 212.0596(2)(e)).

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