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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LEGISLATIVE, ADMINISTRATIVE AND JUDICAL UPDATE

Request for Nexus Clarification

A Delaware corporation has asked the US Supreme Court to rule on whether physical presence is required for the application of all State tax, or just for sales and use taxes. (A & F Trademark, Inc. v. Tolson, filed June 2, 2005).

"Bricks and Mortar" Affiliate Can Constitute Nexus

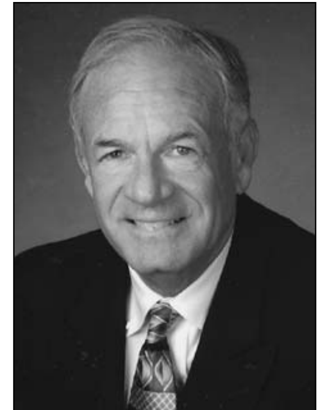
A California court has decided an out-of-state corporation had nexus in California because its "bricks and mortar" affiliate acted "as agent" when it accepted returns of merchandise purchased online. (Borders Online, LLC v. State Board of Equalization, CA Court of Appeal, First Appellate District, No A105488, May 31, 2005).

Proposed Federal Legislation Requires Physical Presence for Nexus

Legislation was re-introduced in the US house of Representatives on April 28, 2005, (H.R. 1956) that would prohibit a State from imposing an income tax or other business activity tax on an entity unless the entity had physical presence in the State. The measure would also extend the protection of the Commerce Clause (P.L. 86-272) to all state business activity taxes. Physical presence would also be defined.

Streamlined Sales and Use Tax Agreement

As of October 1, 2005, the Streamlined Sales and Use Tax (SST) Agreement will officially go into effect with 18 member States.



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 34 YEARS.

LLC Owner Responsible for Employee Tax Withholding

A Kentucky District Court held that an individual that owns a single member Limited Liability Company ("LLC") is personally liable for the company's failure to pay withholding tax and social security tax for the company's employees.

US Citizens Will Require Passports to Re-Enter the US

The US Department of Homeland Security has announced the staggered introduction of rules requiring US citizens returning from trips outside the US to have US passports. US citizens entering from Canada will not be affected until the end of 2006. However, US citizens entering from the Caribbean may be affected by the end of 2005.

"Good" Nexus News from South Carolina

South Carolina has decided that "nexus" for purposes of corporate income tax and license fee purposes will be determined without regard to whether the corporation owns or utilizes a distribution facility within the State. (H.B. 3006, Laws 2005, applicable to taxable years beginning January 1, 2006).

*ADDRESSES ONLY U.S. FEDERAL ISSUES -- STATE AND LOCAL ISSUES MAY ALSO APPLY.
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IRS CHANGES PROCEDURES FOR REAL ESTATE SALES FOR NONRESIDENT ALIENS

Readers are aware, unless an exception applies, if you are a nonresident alien of the US and you sell US real estate, a withholding tax of 10% of the selling price is collected at the time of sale and sent to the IRS as a prepayment of any US income tax that may be due.

The closing agent will prepare IRS Form 8288-A in duplicate and send it the IRS along with the tax. A temporary copy of Form 8288-A will normally also be given to you. (It is your temporary receipt for your tax that has been sent to the IRS). When you file your US income tax return to report the sale you must include a copy of Form 8288-A to prove that amount of tax was paid.

Until recently, the IRS would automatically stamp the duplicate copy of Form 8288-A that it received from the closing agent, and would send the stamped duplicate copy back to you as your "official" receipt of the tax paid. This was sent to you regardless of whether you held a US taxpayer identification number. You would then attach this official receipt to your income tax return to claim credit for the tax paid.

However the IRS has now ceased returning the stamped copy of Form 8288-A to you unless you have a US taxpayer identification number (an ITIN). In this case you will receive a letter from the IRS stating:

"We are sending this letter to inform you that we are unable to mail your Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests (USRPI), because you did not supply us with your U.S. tax identification number (U.S. TIN)."

This letter may unnecessarily alarm you. It appears the IRS will still give you credit for the tax withheld and sent to the IRS as long as you attach to your US income tax return the temporary copy of Form 8288-A that you were given by the closing agent.

However if you wish to ensure the IRS will, in fact, return the "official" stamped copy of Form 8288-A to you, rather than sending the above letter to you, you can arrange for the closing agent to attach a complete IRS Form W-7 to Form 8288-A when the latter is submitted to the IRS. Form W-7 is the application to obtain a taxpayer identification number (ITIN). Be sure to comply with the documentation requirements as set out in the instructions to Form W-7.

CANADIAN BUSINESSES MAY HAVE US STATE SALES TAX REQUIREMENTS

We previously mentioned the three main State tax issues that might impact Canadian corporations conducting business in the US, namely:

1) State corporate income tax,
2) State corporate franchise tax, and
3) State sales tax.

State sales tax is "dangerous" because the threshold for liability may be lower than that for State income tax.

For example, whereas the presence in a State of an independent agent without the authority to conclude contracts will not generally subject you to State income tax, the presence of such an agent will generally subject you to State sales tax. Other types of presence in a State may also subject you to State sales tax. For example, participation in a trade show as an exhibitor may trigger sales tax liability even if no sales are concluded at the show.

Generally some type of a "physical presence" in a State is necessary to trigger sales tax in that State. However each State has its own idea of what constitutes physical presence and their ideas are not static.

Also, even if you have "physical presence" in a State you may not actually have a sales tax obligation there because each State has a separate and distinct set of products or services that are exempt from the tax. Further, the States conduct their exemptions differently - in some States you still must register and report exempt sales even though they are not taxable. In some other States you are not required to even register for exempt sales, let alone report the sales.

Please refer to Exhibit 1 and consult your tax advisor before taking any action.

INTEREST EXPENSE DEDUCTIONS, (PART 2 - NON-RESIDENT ALIENS AND FOREIGN CORPORATIONS)

We summarized the rules for interest deductions for US citizens and US resident

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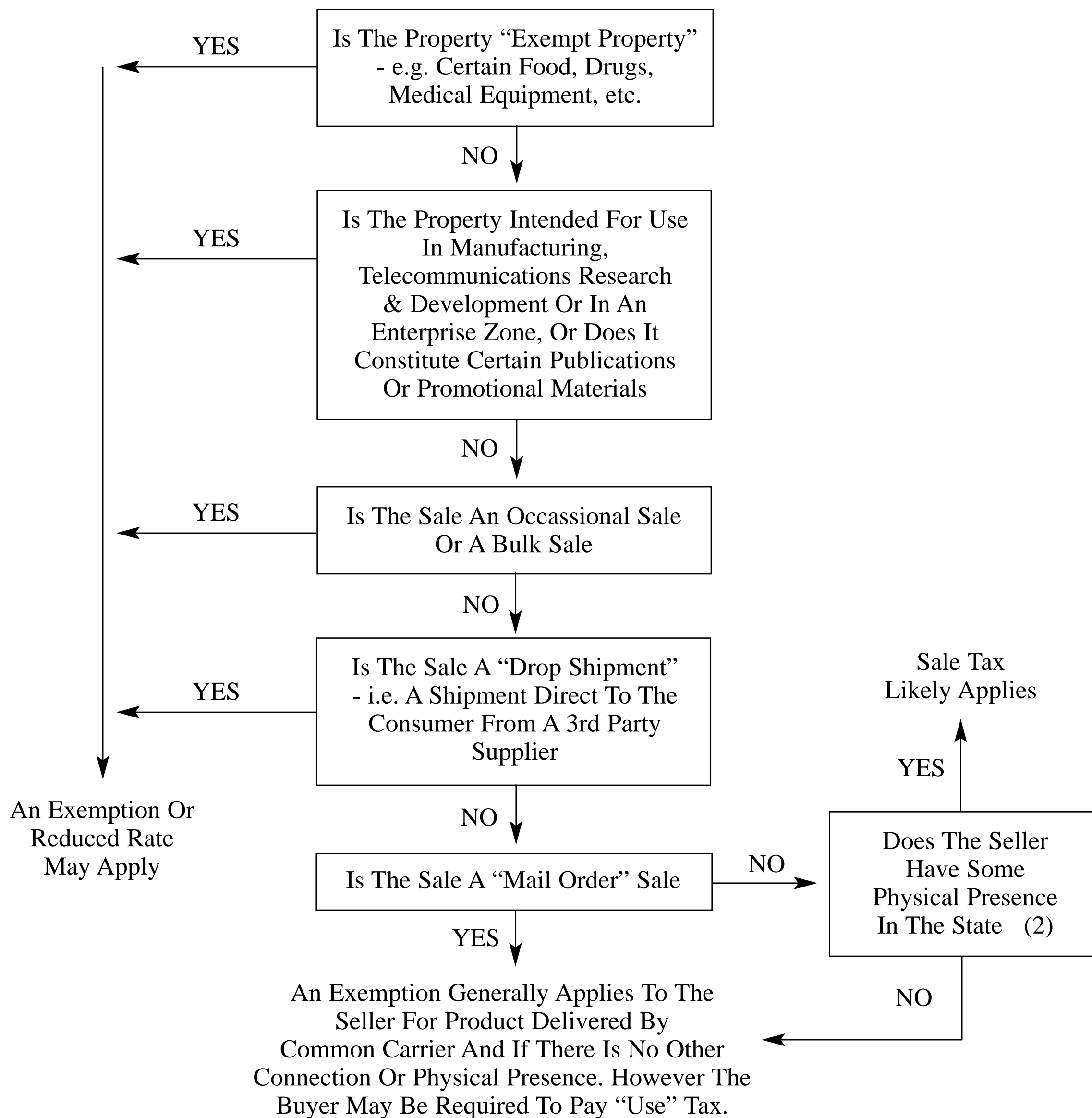
individuals in the last issue of the Taxletter. Set out below is a summary of the rules applicable to nonresident aliens and non-US corporations that file US income tax returns.

Nonresident Aliens

Nonresident aliens are generally only allowed to take a deduction for an expense on a US income tax return (IRS Form 1040NR) if the expense is connected with a US trade or business. Real estate rental activity is automatically considered connected with business if there is sufficient activity. If there is insufficient activity, you can make an election to treat the rental income (and thus expense) as being connected with US business. (Interestingly, once properly elected,

EXHIBIT 1

State Sales Tax And The Sale Of "Tangible Personal Property" To The Ultimate User (1)



(1) Note That An Exemption Generally Applies To "Sales For Resale".
(2) Physical Presence May Include Sales Representatives, Employees, Or Independent Contractors, Even If They Have No Authority To Conclude Contracts. It May Also Include The Operations Of Affiliates, And Attendance At Trade Shows.

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the election applies to other non-personal-use real estate. Thus for example, in some cases it may permit you to deduct interest and taxes on vacant land).

Interest expense incurred by a nonresident alien is considered connected with US business (and therefore potentially deductible) only to the extent it is incurred with respect to liabilities that:

1) Are secured by assets that generate income connected with US business, or

2) Are entered on the books and records of the US business when incurred.

(See Reg. 1.861-9T(d)(2)).

The regulations essentially provide a 4:1 debt to equity limitation on the amount of debt for which a deduction can be taken – i.e. the debt for which a deduction is taken cannot exceed 80% of the gross assets of the US business.

If the debt is secured by specific assets other than the US business assets the interest is not deductible. This limitation does not apply if the only security is the general credit of the individual.

Example: Myron purchases a US rental apartment building for $500,000 and places a $450,000 mortgage on the property. The first year's interest expense for the full year is $25,000. Since the mortgage liability exceeds $400,000 (80% of the value of the building) Myron can only deduct $22,222 in interest expense. (400/450 x $25,000).

Non-US Corporations

As in the case of nonresident aliens, an expense incurred by a non-US ("foreign") corporation is generally allowed as a deduction on a US income tax return (IRS Form 1120-F) only if the corporation has US trade or business income with which the expense is connected.

However the rules for determining the amount of deductible interest for a foreign corporation are completely different than the rules for nonresident aliens.

To determine the interest deduction on a US income tax return for a foreign corporation you must choose to use either the "adjusted book liability ("ABL") method, or a modified "separate currency pools" method. The ABL method may be slightly simpler and is described here.

To compute the interest deduction under the ABL method you go through a three–step process as follows:

Step 1: Determine the total value of the corporation's "US assets" – i.e. assets that generate or could generate income considered connected with US business. (You may elect to value all US assets at fair market value rather than adjusted basis).

Step 2: Multiply the value of its "US assets" (from above) by a "liability-to-asset ratio" to determine the corporation's "US-connected liabilities". You can make a one-time election to use either a fixed ratio (generally 50% for non-banks), or the corporation's actual liability-to-asset ratio.

The actual ratio is the ratio of the corporation's worldwide liabilities for the year to the total value of its worldwide assets for the year.

Step 3: The interest expense deduction is then determined by starting with the amount of actual interest expense paid by the US branch on the liabilities shown on the US branch's books (the "US–booked liabilities").

"US-booked liabilities" are liabilities "properly reflected" on the books of the US business. Except for banks, a liability is generally "properly reflected" if either:

1) The liability is secured predominantly by US assets of the corporation, or

2) The corporation enters the liability on a set of books relating to an activity that produces income connected with US business, at a time "reasonably contemporaneous" with the time at which the liability is incurred, or

3) The corporation maintains a set of books and records relating to an activity that produces income connected with US business and the IRS agrees there is a connection with the business.

The deductible interest is finally arrived at by adjusting the actual interest paid by the US business upward or downward, depending on whether the "US-booked liabilities" are less, or more, than the "US connected liabilities" determined in Step 2. The adjustment is made by a scaling ratio - i.e. by the ratio of "US-connected liabilities" to "US-booked liabilities."

Example: X Corporation, a hypothetical Canadian corporation has activities, assets and debts in Canada, but it also owns a US rental apartment building that was purchased with a US mortgage.

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The corporation's facts for its latest fiscal year are as follows:

Total value of US assets	$700,000
US-booked liabilities	500,000
Worldwide liabilities or the year	800,000
Worldwide assets for the year	2,000,000
Liability-to-asset ratio (ratio of worldwide liabilities to worldwide assets)	40%
Interest expense shown on the US books	$40,000

Step 2: Computation of US-connected liabilities: 700,000 x 40% = 280,000.
Step 3: Computation of interest deduction:

Since the US-booked liabilities exceed the US-connected liabilities, the interest paid by the US branch ($40,000) must be "scaled back" as follows:

Scaling ratio: 280,000/500,000 = 56% (US-connected liabilities/US-booked liabilities)

Deductible interest 56% x $40,000 = $22,400.

If the US-connected liabilities exceed the US-booked liabilities, the deductible interest is scaled up, but not beyond the corporation's total worldwide interest for the year. (Reg. 1.882-5(a)(3)).

Although scaling up may sound advantageous (since it may provide an interest deduction exceeding the amount of interest paid by the branch) the corporation may then be subject to the "branch level interest tax". (See IRC 884). In this case you are permitted an election to reduce your US-connected liabilities. (See reg. 1.884-1(e)(3)).

Also special rules apply for payments to related parties.

SECTION 1031 REAL ESTATE EXCHANGES BECOMING "HOT"

The US has two different provisions that may apply to eliminate or defer US tax on the sale of real estate, as follows:

1) The principal residence exemption. Under this provision the first $250,000 or $500,000 of gain on the sale of your principal residence may be free of US income tax if you meet all the requirements, including the 2 year rule. (Please consult your tax advisor). The provision generally also applies to Canadian residences owned by US citizens (and certain green card holders) living in Canada.

It normally does not apply to nonresident aliens who sell a US residence because the residence must genuinely have been your principal residence during the required period.

2) The "1031" tax deferred exchange. Under this provision, your tax can be deferred, but not necessarily forgiven. Among other circumstances, Section 1031 of the US Internal Revenue Code provides for a deferral of US income tax if real estate held for investment is exchanged solely for real estate of a like kind which is to be held for investment. US domestic real estate and foreign real estate are not "like kind". Many other exceptions and special rules apply – please consult your tax advisor. Unfortunately the "1031" tax deferred exchange provision may not be useful to many Canadian residents because there may be no simultaneous deferral for Canadian income tax purposes.

The most common use of the "1031" provision in the real estate "investment" context is probably the exchange of rental real estate or vacant land for other rental real estate or vacant land.

The exchange can involve:

1) A two party simultaneous exchange,
2) A multi-party simultaneous exchange,
3) A delayed (forward) exchange, or
4) A reverse exchange.

Two Party Simultaneous Exchange

This is, of course, the simplest situation.

Example 1: You purchased a US condo for $100,000 that has been used solely as rental property. It is now worth $400,000. You meet another individual (Roger) that owns another condo in the same condominium building worth $425,000. Roger prefers your condo and you prefer his. If you exchange condos with Roger (and pay him the $25,000 difference) you may qualify for a US income tax deferral provided all requirements are adhered to, including continuing to use your condo as rental property. (Roger may have tax to pay, depending on his own circumstances).

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Multi-Party Simultaneous Exchange

Of course it is rare that a person that wants to buy your property also owns property that you wish to buy. Hence it can become necessary to have a three-party or four party exchange. A three party exchange consists of you (the "exchangor"), a prospective purchaser of your property (the "buyer") and a prospective seller (the "seller") of the property that you wish to acquire (the "exchange property").

In this three-party exchange the "buyer" of your property may be expected to buy the "seller's" property and then conduct the exchange with you.

However the "buyer" in this example may not want to get involved in the exchange and/or for other reasons, a fourth party may be required. There are many requirements for a four-party exchange. However if a "Qualified Intermediary" (a "Q.I." or an "accommodator") is used, there is a safe harbor provision available.

The Q.I. can acquire the "exchange property" you want from the seller and exchange it with you for your "old" property. He simultaneously transfers your "old" property to the "buyer" that wants your property. A provision exists to permit the avoidance of a second set of land transfer taxes on each transfer so the "Q.I." does not appear on the deeds. Please refer to Exhibit 2.

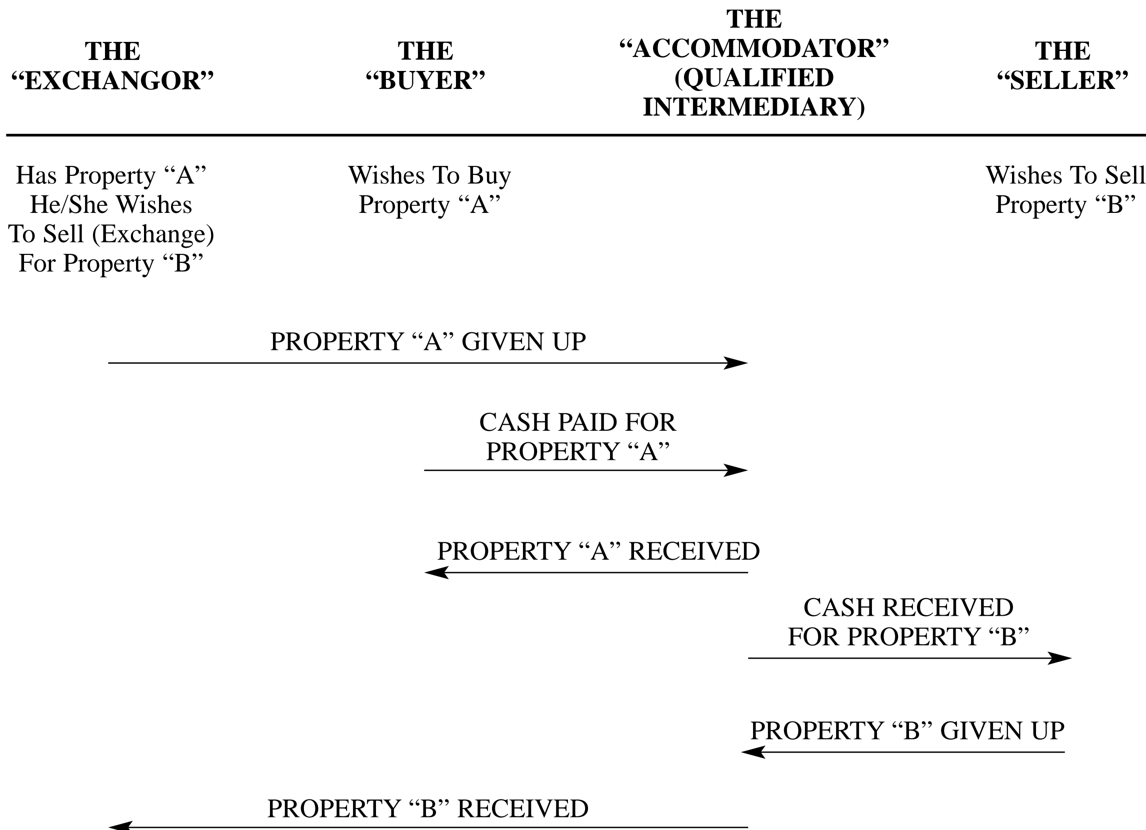
Delayed Exchange

If you wish to give up your property via an exchange and you have a buyer for your property but you have not yet located a property you wish to acquire you can undertake a <u>delayed</u> exchange.

In this case you can transfer your property to the Q.I. and you have 45 days after the transfer to locate and <u>designate</u> the property

<u>EXHIBIT 2</u>

An Example Of A Tax-Deferred Exchange Under Section 1031



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you wish to acquire in exchange. You then have 180 days after the transfer to actually acquire the new property, (which occurs via the Q.I.).

Your acquisition of the new "exchange property" must also occur before the due date (including extensions) for your US income tax return for the year of transfer.

Reverse Exchange

You may have located a property you wish to buy now, and you have a property you wish to sell but you have not located a buyer yet for your property. In this case it is potentially possible to proceed now to close on the new property and eventually sell your other property under the 1031 tax-deferred exchange provisions.

A separate "closing agent" is usually involved regardless of which type of exchange occurs.

Please consult you tax advisor before taking any action.

CANADIAN EXECUTOR'S AND HEIR'S LIABILITY FOR UNPAID US ESTATE TAX

The estate of a nonresident alien must file a US estate tax return if the deceased individual owned more than $60,000 in US property at the date of death. US property includes, among other assets, the value of US stocks held in Canada, even if they are held in an RRSP or RRIF.

Often the estate tax return is not timely filed, sometimes because the surviving spouse and others are not even aware the filing is required. (The IRS does not monitor such deaths and hence does not "knock on the door" to advise you of the requirements).

The filing requirement may only be discovered years after the death when the heir decides to sell the property and the sale comes to a halt when it is discovered estate tax releases were not obtained. By that time substantial penalties and interest may have accumulated.

(Occasionally, however, settlement agents that close such real estate sales inadvertently apply estate tax law applicable to US citizens rather than nonresident aliens, and thus close the sale without regard to the proper cross border estate tax release procedures. This subjects the unknowing settlement agents, as well as others to a contingent liability for unpaid estate tax).

Suppose an estate tax liability is triggered upon the death of a nonresident alien but the estate tax return is not filed. Who is liable for the tax?

Swarming tentacles of liability may extend in many directions, depending in part on such facts as:

1) Whether an estate tax return is eventually filed (in which case the statute of limitation rules may then commence),
2) Whether court probate was required, or
3) Whether there is an executor appointed within the US.

Transferee Liability – Non-Probate Assets

If a joint owner of property receives property subject to US estate tax, the joint owner (the "transferee") is personally liable for the unpaid estate tax, at least to the extent of the value of the property received. (IRC 6324(a)(2)).

The transferee's liability may also include interest due on the tax (Govern Estate v. Commissioner. (T.C. Memo 1996-434).

The liability generally ceases after the estate tax return has been filed and the statue of limitations has run its course. (Generally 4 years in the case of "transferees").

Example 1: Brian and Lucille (nonresident aliens) jointly own their US condo valued at $400,000. Brian passes away and Lucille and her advisors are unaware of the requirement to file a US estate tax return for Brian's estate.

Fifteen years later Lucille decides to sell the condo. At the time of closing the sale the closing agent discovers the earlier death of Brian. At that time it will be necessary for Brian's estate to file an estate tax return and pay any estate tax, penalties and interest that are due. Failure to do so will subject Lucille to liability. See also "Transfer Certificates" below.

Executor (Fiduciary) Liability

The executor of an estate may have a broader liability than the transferee liability described above. A representative of an

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estate that pays a debt or makes a beneficiary distribution is liable to the extent of that payment for unpaid claims of the Government. (31 USC 3713(b)).

Alarmingly, if there is no executor or administrator appointed, qualified, and acting within the US, then any person in actual or constructive possession of any property of the decedent is considered an executor (referred to as "statutory executor") and subject to liability for unpaid tax. (IRC 2203).

Hence, certain Canadian accountants, lawyers, financial planners, real estate closing agents and others may have a contingent liability for US estate tax as a statutory executor.

The executors may be released after the estate is settled and they are dismissed under local law.

Example 2 The facts are the same as Example 1, except Brian also solely owned $100,000 in US stocks in Canadian brokerage accounts, including $25,000 in his RRSP. Brian's Canadian CA "William" is co-executor of Brian's estate and is in charge of liquidating assets and disbursing them in accordance with Brian's will. Brian may have a personal liability as a "statutory executor" for unpaid estate tax on the US condo and the US securities in Canada.

Transfer Certificates

Fortunately a provision exists to help protect statutory executors. For example when US real estate is being sold, or when it is desired to liquidate a US securities account, an application can be made to the IRS for a "release". Under this procedure, the IRS will agree to release specified assets for sale, provided a prescribed amount of the proceeds are held in escrow until the federal "Estate Closing Document" is issued. (See Reg. 20.6325-1).

Gift Tax

Transferee liability also applies in the case of gifts. If a nonresident alien makes a taxable gift of US real estate to another individual and the gift tax is not paid, the transferee (donee) is personally liable for the tax.

Example 3: Roger and Edith (nonresident alien spouses) purchase a US condo jointly for $300,000. Five years later when the condo is valued at $600,00 they add their son Caspar to the deed as a joint owner. It is likely a gift of $200,000 (less the exclusion in effect for that year) has been made to Caspar. If the gift tax is not paid Caspar may be personally liable for the tax (along with Roger and Edith).

US TAX INSTALLMENTS REQUIRED BY CORPORATIONS

Income tax installment payments (referred to as "estimated" tax payments in the US) must generally be made during the course of the year if a corporation will have a US income tax liability for that year. In addition to a US federal estimated tax payment, an individual State estimated tax payment may also be required if the corporation has income (or was formed) in a State that has an applicable corporate income tax. Penalties apply for noncompliance.

US Federal Requirements

Domestic and foreign corporations generally must make four equal installments of federal estimated tax if the year's tax liability is expected to exceed $500. The payments are made with preprinted IRS Form 8109 and are due on the 15th day of the 4th, 6th, 9th, and 12th month of the corporation's tax year.

Preprinted Forms 8109 are issued in booklet form by the IRS as a result of applying for a US tax ID number (or if a tax return is filed without a number). You can obtain a substitute Form 8109-B by calling the IRS at 1-800-829-4933 provided you have a tax ID number.

To be assured of avoiding a penalty for underpayment of federal estimated tax you must ensure that timely estimated tax payments were made at least in one the following amounts:

1) The tax shown on a tax return for the prior year (but this exception only applies if a return was filed for the prior year showing a tax liability and it covered 12 months), or

2) A tax amount computed using current tax rates but based on the prior year's income, (but this exception only applies if a return was required for the prior year), or

3) An amount equal to 70% of the tax computed by placing the current year's income on an annual basis.

(See Reg. 1.6655-2).

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Technically there is no automatic first year exemption from making estimated tax payments. However the IRS seems (so far) to have been lenient with foreign corporations filing for the first time.

Please refer to Exhibit 3.

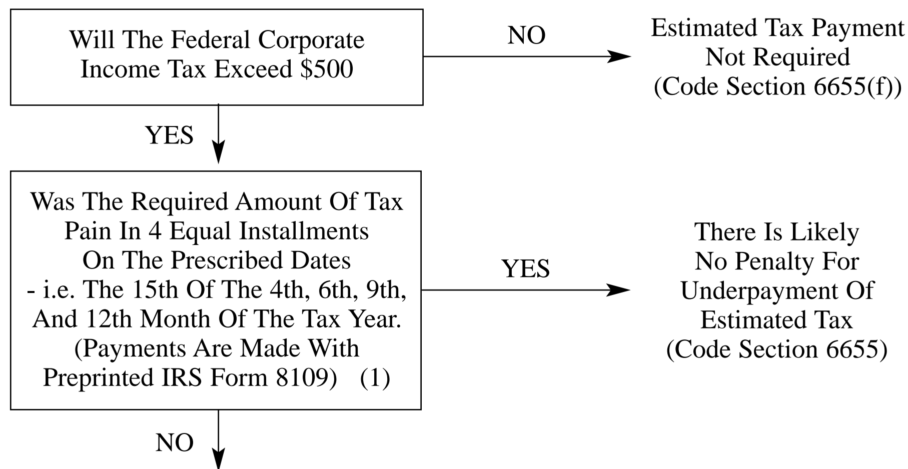
As a separate matter, the due date for the corporate income tax return for domestic corporations and "foreign" corporations having an office or place of business in the US is the 15th day of the 3rd month following the close of the tax year. The due date for other foreign corporations is the 15th day of the 6th month after the close of the tax year. (IRC 6072).

Florida Requirements

Each State has it own distinct requirements. In Florida, for example, an "Estimated Tax Declaration", (Form F-1120-ES), and tax installment must be made if the Florida tax

EXHIBIT 3

Federal Rules For Corporate Estimated Tax Payments



Pursuant To Code Section 6655 And Reg. 1.6655-1 A Penalty For Underpayment Of Estimated Tax Might Be Imposed. However Per Reg. 1.6655-2 It Will Not Be Imposed If The Timely Estimated Tax Payments Made Were At Least:

a) The Tax Shown On A Tax Return For The Prior Year (But This Exception Only Applies If A Return Was Filed For The Prior Year Showing A Tax Liability And It Covered 12 Months), Or
b) A Tax Amount Computed Using Current Tax Rates But Based On The Prior Year's Income, (But This Exception Only Applies If A Return Was Required For The Prior Year), Or
c) An Amount Equal To 70% Of The Tax Computed By Placing The Current Year's Income On An Annual Basis.

(1) The Required Amount Of Tax Is The Lesser Of:
a) 100% Of The Tax Due For The Current Year, Or
b) 100% Of The Tax Shown On The Tax Return For The Prior Tax Year.
This Paragraph b) Does Not Apply If The Prior Tax Year Did Not Cover 12 Months, Or If A Tax Return Was Not Filed For The Prior Year Showing A Tax Liability, Or If The Corporation Is A "Large" Corporation.
(Code Section 6655 And Instructions To Forms 1120 And 1120-F)

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liability will exceed $2,500. The requirement applies regardless of whether the corporation is a domestic or foreign corporation, and it applies even if it is the first Florida tax filing for the corporation.

Under F.S. 220.34(2)(d), if a required declaration and appropriate tax installments are not made, the penalty for underpayment of estimated tax is based on a computation using an amount of tax equal to the lesser of:

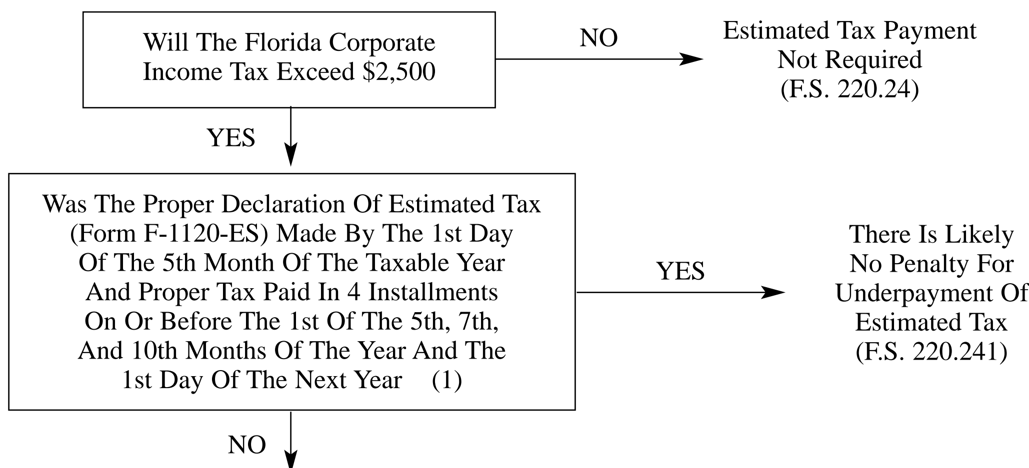
1) The amount equal to 90% of the tax finally due for the taxable year, or

2) The amount of tax at current rates computed on the amount of income shown on a return for the prior year. This paragraph 2. only applies if a return was actually filed for the prior year and, generally, if it was for a 12 month period. (Florida Administrative Code 12C-1.034(9)(b)(1a.))

Please refer to Exhibit 4.

EXHIBIT 4

Florida Rules For Corporate Estimated Tax Payments



Pursuant To F.S. 220.34(2)(d), A Penalty For Underpayment Of Estimated Tax Will Be Based On An Amount Of Tax Equal To The Lesser Of:

a) The Amount Equal To 90% Of The Tax Finally Due For The Taxable Year, Or

b) The Amount Of Tax At Current Rates Computed On The Amount Of Income Shown On A Return For The Prior Year. This Paragraph b) Only Applies If A Return Was Actually Filed For The Preceding Year And Generally If It Was For 12 Months. (Florida Rule 12C-1.034(9)(b)1.a).

(1) Except, If The Minimum Tax Requirement Of $2,500 Is First Met
- a) After The 3rd Month And Before The 6th Month Of The Taxable Year The Declaration Is Required By The 1st Day Of The 7th Month And Tax Paid In 3 Installments,
- b) After The 5th Month And Before The 9th Month, The Declaration Must Be Filed By The 1st Day Of The 10th Month And Tax Paid In 2 Installments
- c) After The 8th Month And Before The 12th Month, The Declaration Must Be Filed By The 1st Day Of The Succeeding Tax Year And The Tax Paid With It.

(F.S. 220.241 and 220.33)

There Is No Automatic Exemption First Year Exemption From Filing The Declaration And Making Estimated Tax Payments. (Florida Administrative Code 12C-1.034(3)(e)). Also, There Is No Provision For "Annualizing" The Income And Computing The Penalty Accordingly. (Florida Administrative Code 12C-1.034(6)).

Unlike The Federal Rule Where A Foreign (e.g. Canadian Postmark) Will Constitute The Actual Date Of Filing, For Florida Purposes Only A U.S. Post Office Mark Constitutes The Date Of Filing. (Florida Administrative Code 12C-1.0222(1)(a)).

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There is no automatic first year exemption from filing the Declaration and making estimated tax payments. (Florida Administrative Code 12C-1.034(3)(e)).

Also, there is no provision for "annualizing" the income and computing the penalty accordingly. (Florida Administrative Code 12C-1.034(6)).

Unlike the federal rule where a foreign (e.g. Canadian) postmark will constitute the actual date of filing, for Florida purposes only a US post office mark constitutes the date of filing. (Florida Administrative Code 12C-1.0222(1)(a)).

Thus, if you have a corporation selling US real estate, (or otherwise having a US tax liability) you may wish to check the individual State's "estimated tax" payment rules at an early date.

As a separate matter, the due date for the Florida corporate income tax return (Form F-1120) is on or before the 1st day of the 4th month after the end of the tax year, or 15 days after the due date of the related federal return. An extension is available provided a tentative amount of tax is paid that results in an ultimate underpayment of tax no greater than the greater of $2,000 or 30% of the tax ultimately shown on the return.

COMPUTATION OF ADJUSTED COST BASE

The adjusted cost base of your real estate (referred to as "adjusted basis" in the US) becomes relevant when you sell your property for purposes of determining your taxable gain (unless of course it is clearly tax free under a principal residence exemption).

Under US rules it is relevant not only for the sale but also for purposes of determining the annual depreciation charge (capital cost allowance) if it is rental property or business property. In the US it is generally mandatory to record depreciation annually on improved real estate rental property and most other business real property except, of course, for land. (An exception may apply in limited cases where foreign owned real estate gross rental income is instead taxed at a flat 30%).

If you purchase improved real estate, your adjusted basis (or "basis") for US purposes includes the purchase price, which includes any liability to which the property was subject that you assumed. Of course any permanent improvements you made to the property also become part of your basis. If the property is a condominium, any assessments by the condominium association for permanent improvements are also added to your basis.

Basis also includes capitalized expenses that are incurred in purchasing the property such as:

1) Real estate broker's commissions,
2) Legal fees,
3) Title search (for purposes of the purchase),
4) Title insurance, (for purposes of the purchase),
5) Transfer taxes (State documentary stamps), to the extent not otherwise deductible, and (among other items),
6) The cost of options to purchase the property.

Loan Costs

The costs of obtaining a loan to purchase property, including the cost of extending or renewing a loan are treated differently because they are considered costs to obtain a loan rather than costs to purchase real estate. These costs are generally not currently deductible. Such costs include:

1) Credit reports,
2) Broker commissions for the loan,
3) Title search and title insurance for the loan,
4) Appraisal costs, and (among other items),
5) Intangible tax.

The deductibility of loan costs depends on the use of the proceeds, not the character of the mortgaged property. (US v. Wharton 207 F.2nd 526).

Rental Property

If the real estate is improved rental property or trade or business property the costs of obtaining a loan to purchase the property are amortized over the period of the loan. When the loan is extinguished a current tax deduction is allowed for the unamortized amount.

"Personal Use" Improved Property

If the real estate is solely personal use property the loan costs are nondeductible, non-amortizable capital expenditures and are not added to the basis of the property.

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(Rev Rul 67-297). However "points" paid to acquire a mortgage loan on a "principal residence" are currently deductible.

Reduction for Depreciation and/or Amortization

Once all the additions to basis are computed, it is necessary to reduce the total by the amount of depreciation and/or amortization that was allowed (or allowable).

Example 1:

Roger and Sarah purchase a US condo on January 1, 2005, for $400,000 cash. The property is purchased from the developer and it is to be used for personal purposes only. At closing they pay the following, in addition to the purchase price:

1) Prepaid condo maintenance fee	$1,200
2) Prepaid property taxes	2,300
3) Title insurance	3,200
4) Document processing	500
5) State documentary tax	2,800
6) Contribution to condo association maintenance fund	1,500
7) Legal fees	1,000
8) Deed recording	10

Roger and Sarah's basis at the time of purchase is computed as follows:

Purchase price	$400,000
Title insurance	3,200
Document processing	500
State documentary tax	2,800
Legal fees	1,000
Deed recording	10
Total	$407,510

Example 2:

The facts are the same as Example 1, except in this case the property is to be used solely for rental purposes, and it is purchased via a 15 year mortgage with the following costs:

Loan origination fee	$3,000
Title insurance on mortgage	500
State intangible tax on mortgage	1,000
Credit Report	50
Loan processing costs	500
Total	$5,050

In this case, Roger and Sarah's basis at the time of purchase is still $407,510. However since it is rental property they may also take an annual deduction of 1/15th of the loan costs of $5,050 in order to amortize these expenses. If the property is sold or the mortgage is repaid, any unamortized costs may be deducted.

CORPORATE SALE OF US REAL ESTATE AND RE-INVESTMENT

As summarized in the article ***"SECTION 1031 REAL ESTATE EXCHANGES BECOMING "HOT" "***, a Canadian or US corporation selling US real estate for a profit can defer its US tax liability by entering into an appropriate "1031 exchange". However in many cases this is impractical and thus the US corporate tax must be paid.

Unfortunately, liquidation of the corporation after the sale may trigger additional tax at the shareholder level. Therefore if it is intended to re-invest the proceeds in US real estate the shareholder may consider using the same corporation to purchase the new property. If the corporation is a US corporation this plan may not have any immediately disadvantageous consequences (but beware the US "accumulated earnings tax").

However if the corporation is a Canadian corporation you must consider the potential applicability of the US "branch" tax. The branch tax is an additional US tax above and beyond the regular US corporate income tax. Although the standard branch tax rate is 30%, several provisions exist in the US tax rules and the tax treaty for Canadians to eliminate the tax or reduce it to 5%, provided the exemptions or reductions are properly claimed.

An additional provision in the US tax code, if properly utilized, can constitute a separate safe harbor to ensure you are exempt from the tax. Under this rule, if you "terminate your US trade or business" (as defined) for three years and file IRS Form 8848, you will be exempt from the branch tax.

If you purchase replacement real estate via the same Canadian corporation and the property does not produce any income and is not sold within the three year period, it may still be possible to comply with the rules for "termination of your US trade or business", thus avoiding the branch tax.

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TRANSPARENT ENTITIES, HYBRIDS, REVERSE HYBRIDS & THE TAX TREATY

The US imposes a 30% withholding tax at source on certain payments of interest, dividends, royalties, etc to non-US recipients. Readers are aware the Canada-US tax treaty provides for certain reductions in the withholding tax rate if the income is received by residents of Canada. For example, IRS Form W-8BEN can be used to claim a reduction in withholding on US dividends from 30% to 15% (5% in some cases).

However sometimes it is unclear whether the ultimate recipient is, in fact, a resident of Canada.

For example, if a Canadian partnership owns shares of a US corporation and the partnership receives dividends from the US corporation, the Canadian partnership itself is likely not subject to Canadian tax on the dividend. Rather it is the partners that are subject to tax. Suppose the partners are not actually resident in Canada and instead are resident in, e.g., the United Kingdom – what is the correct US withholding tax rate on the dividends?

Or suppose the partners in the partnership are partnerships themselves - what is the correct US withholding tax rate?

To address this, the US has rules that apply to "fiscally transparent entities". Of course a fiscally transparent entity is generally an entity that is a flow-through entity for income tax purposes – i.e. generally does not have a tax liability itself. It is the "owner(s)" or "interest holder(s)" that have the tax liability.

For a definition of "fiscally transparent" please refer to Temporary Reg. 1.894-1T(d)(4).

Readers are aware, if the entity is fiscally transparent in one jurisdiction, (e.g. the US) but not in another jurisdiction, (e.g. Canada) it is referred to (from the US perspective) as a "hybrid". This type of hybrid is a regular hybrid. An entity that is the opposite, (fiscally transparent in Canada but not in the US) is referred to (from the US perspective) as a "reverse hybrid".

Thus, for example, if a US LLC taxed as a partnership in the US passes through a dividend payment from a US corporation to a Canadian recipient, special rules apply to determine whether the dividend payment is subject to the regular US withholding tax rate of 30%, or whether the Canada-US tax treaty rate apples, (or some other tax treaty rate).

Similarly, if a US corporation pays a dividend to a Canadian partnership the transaction may be entitled to reduced US withholding at source only if the partners themselves are not fiscally transparent.

For a summary of some of these rules please refer to Exhibit 5. The rules are complex - please consult you tax advisor before taking any action.

Another issue involving cross-border transactions and fiscally transparent entities arises in the case of claiming a tax credit on a US income tax return for foreign (non-US) taxes paid through transparent entities. Please see "***CLAIMING FOREIGN TAX CREDITS WITH FISCALLY TRANSPARENT ENTITIES***".

U.S. "PORTFOLIO INTEREST" IS FREE OF U.S. INCOME TAX FOR SOME NONRESIDENT ALIENS

Many Canadians are aware that U.S. bank interest is not subject to U.S. income tax if you are a nonresident alien of the U.S. and the interest is not connected with your U.S. business.

In addition, certain interest that qualifies as "portfolio interest" is also exempt from U.S. tax if you are a nonresident alien and all requirements are met.

The provision to exempt portfolio interest from income tax may be especially useful to Canadians selling US real estate and taking back a mortgage on the sale. A properly structured note and mortgage can avoid the need for US tax withholding at source by the borrower/buyer, and the filing of a US income tax return by you to report the interest received.

Among other circumstances, "portfolio interest" includes interest paid on debt that is in registered form, as long as all requirements are met.

Debt is treated as being in registered form if:

1) It is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the debt may be

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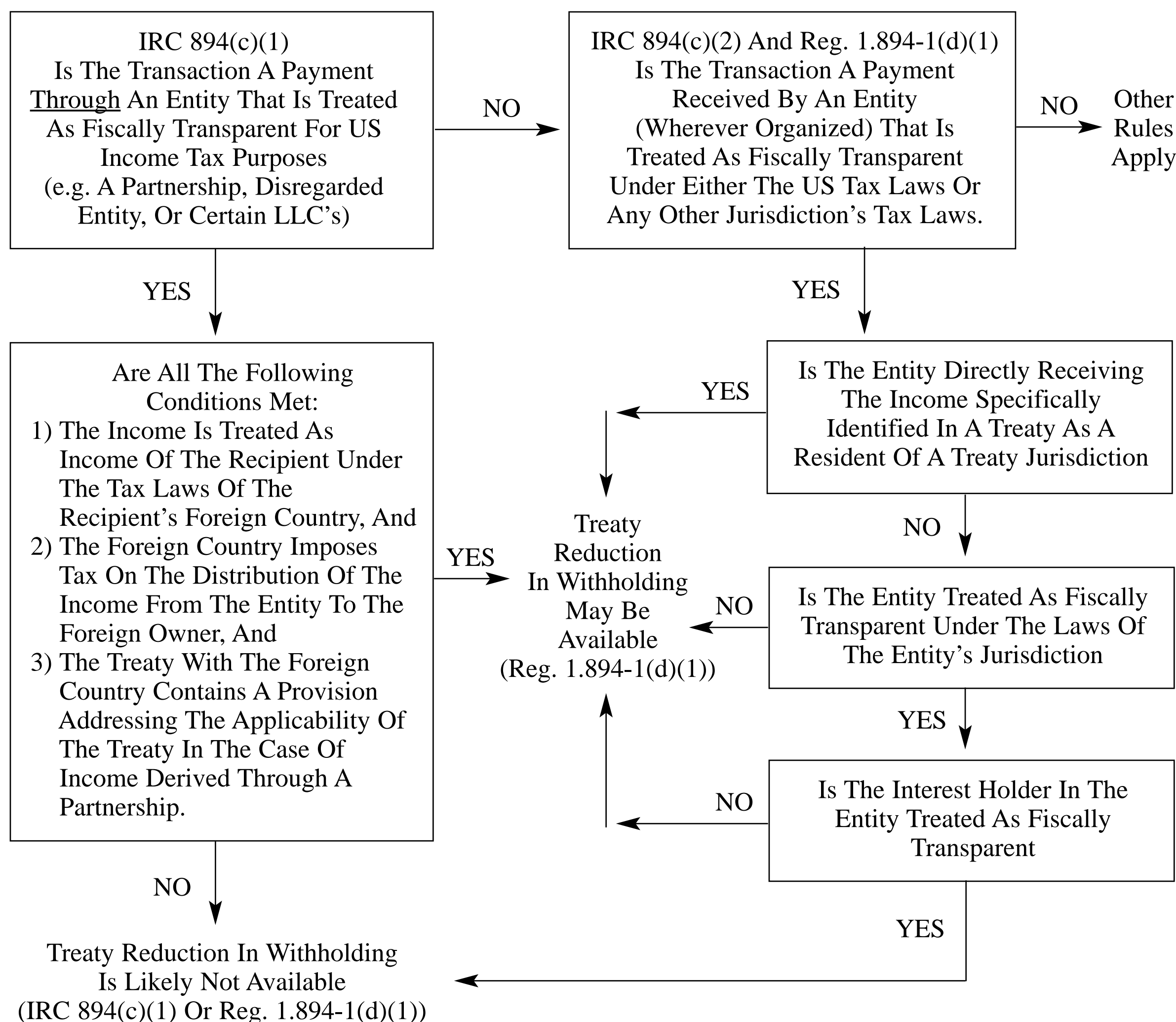
EXHIBIT 5

Availability Of Treaty Withholding Tax Benefits For Payments Received By, Or Through Transparent Entities (1) (2)



(1) Regulation 1.894-1T(d)(4) States That An Entity Is Treated As Fiscally Transparent By A Jurisdiction To The Extent The Jurisdiction Requires Interest Holders In The Entity To Take Into Account Separately On A Current Basis Their Respective Shares Of The Items Of Income Paid To The Entity And To Determine The Character Of Such Items As If Such Items Were Realized Directly From The Source From Which Realized By The Entity (For Purposes Of The Tax Laws Of The Jurisdiction). See Also Reg. 1.954-9(a)(7).

Entities That Are Fiscally Transparent Entities For US Federal Purposes Include (But Are Not Limited To) Partnerships, Grantor Trusts, Entities Treated As Disregarded Entities And Certain LLC's Treated As Partnerships Or Disregarded Entities.

Entities That Are Treated As Fiscally Transparent For US Purposes But Not Fiscally Transparent In Another Jurisdiction Are Referred To As Hybrid Entities.

Entities That Art Treated As Fiscally Transparent In Another Jurisdiction But Not In The US Are Referred To As Reverse Hybrids.

(2) The Rules Are Very Complex - Please Consult Your Tax Advisor Before Taking Any Action.

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effected only by surrender of the old instrument and, either the reissuance by the issuer of the old instrument to the new holder, or the issuance by the issuer of a new instrument to the new holder", or

2) "The right to the principal of, and stated interest on, the obligation may be transferred only through a book–entry system maintained by the issuer (or its agent)", or

3) "It is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either 1. or 2. above".

(See Reg. 1.871-14(c)).

Among other requirements, the following also apply for the exemption:

1) The debt must have been issued after July 18, 1984,

2) The U.S. issuer/withholding agent must receive a statement from you confirming that you are not a U.S. person. (IRS Form W-8BEN may be adequate for this purpose),

3) A "10% owner" of the payer cannot qualify to receive portfolio interest and, of course,

4) The interest must not be connected with US business.

US corporations issuing debt obligations after December 31, 1982, will normally attempt to comply with the registration requirements. Otherwise they may be unable to claim a deduction for the related interest expense unless an exception applies. (Reg. 5f.163-1).

There are additional rules that may apply. Therefore please do not take any action without receiving authoritative confirmation that the bond, note, etc. that you are considering, properly qualifies as a portfolio interest debt instrument.

The payer of the interest generally is required to issue IRS Form 1042-S annually to you and to the IRS to report the payment of the interest to you and to report the basis for the payment being free of U.S. withholding tax.

CLAIMING FOREIGN TAX CREDITS THROUGH FISCALLY TRANSPARENT ENTITIES

The article "***TRANSPARENT ENTITIES, HYBRIDS, REVERSE HYBRIDS & THE TAX TREATY***", summarizes some rules that apply when attempting to claim tax treaty benefits in cross border circumstances involving transparent entities.

Another cross-border issue involving taxes and transparent entities arises with claims for foreign tax credits. Suppose, for example, a US partner in a US LLC (that is taxed as a partnership in the US) receives Canadian source business income that is earned in Canada and then passed through to the US partner after being subjected to income tax in Canada.

Although the rules can be complex, (see Reg. 1.704-1T(b)(4)(xi)), generally a pro-rata portion of the Canadian tax paid by the LLC is potentially available as a foreign tax credit to the US partner.

Of course the foreign tax credit is only actually usable by the US partner to the extent he/she has the appropriate "foreign source income" as defined under the US rules for claiming foreign tax credits.

So, does the income passed through the LLC to the US partner constitute appropriate "foreign source income"? (i.e. what is the income's character). Is it considered "foreign source" and is it properly allocable to the appropriate categories or baskets required for foreign tax credits - i.e. passive, high withholding, general limitation, etc.

Fortunately, although the rules may be complex, the US partner's share of partnership income is characterized according to the category in which it was earned in the partnership. (See Reg. 1.904-5(h)(1) and Reg. 1.704-1T(b)(4)(xi), Example 25).

However an exception may occur for certain corporate or limited partners in some cases. (See Reg. 1.904-5(h)(2)).

CANADA-US LANDLORDS (AND SOME BUSINESSES) - BEWARE IRS FORM 1099

If you are engaged in a US trade or business (which may include individuals or corporations that rent out their US real estate) you may have an obligation to file IRS Form 1099-MISC. Penalties may apply for noncompliance.

If you are engaged in business you may be required to report on Form 1099-MISC certain payments you make to others in the course of your business. Such payments may include payment for services, rents, or gross

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proceeds paid to an attorney. Exceptions apply (among other situations) for a particular payee if:

1) Your aggregate annual payments to the particular payee are less than $600, or

2) The payment is to a corporation. This corporate exemption does not apply to certain attorney's fees for legal services, or gross proceeds paid to an attorney.

Of course the requirement also applies to payments to "independent contractors" that are not incorporated.

REVIEW OF US TAXPAYER NUMBERS FOR NONRESIDENT ALIENS

The IRS requires a nonresident alien individual to have a US taxpayer identification number to:

1) File a US income tax return, or

2) File a "FIRPTA" withholding certificate application. (This is an application whereby you request a reduction in the 10% withholding tax that normally applies to the sale of US real estate).

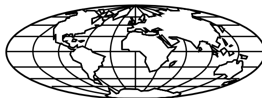
Unless you are eligible for a US social security number you obtain an *individual taxpayer identification number* (ITIN) from the IRS. The number is obtained by filing IRS Form W-7 with the tax return, or withholding certificate application, as the case may be. A number is not required at the time of sale of US real estate sale. (However please see the article *"**IRS CHANGES PROCEDURES FOR REAL ESTATE SALES FOR NONRESIDENT ALIENS**")*.

Other instances may arise where a number is requested of you, but in these cases special procedures must be undertaken to obtain the number. For example, if you are a partner in a US partnership, or if you are receiving real estate rental income, the partnership, or rental agent, as the case may be, may demand that you provide an ITIN. In these cases you can file a "free standing" Form W-7 without a tax return, but you must attach evidence of why the number is required. Please see exceptions #1- #4 to the instructions to IRS Form W-7.

OBTAINING COPIES OF YOUR TAX RETURNS FROM THE IRS

To obtain a copy of a prior US tax return you filed you can submit IRS Form 4506 to the IRS along with payment of $39 for each return you are requesting. The IRS generally keeps income tax returns for 7 years from the date of filing. Other returns may be available longer. The processing period is approximately 60 days.

On the other hand, if a transcript of your return would be adequate, you can submit IRS Form 4506-T to the IRS. In this case there is no fee and you will likely receive the IRS response much faster. You can even arrange for the IRS to send the transcript directly to a third party, (e.g. a bank) if you wish.



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