Kotler van den Brink & Company
U.S. & International Tax Consultants

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The U.S.TAXFAX

TOPIC: TAX TRAPS FOR THE UNWARY

After a bit of a break from writing the U.S. TAXFAX we have decided to resurrect its publication. This edition will discuss a few of the current **tax traps for the unwary**. These are situations where it is important to address the U.S. and Canadian tax consequences of a particular transaction before making the final decision to proceed. Check out our web page at **www.kvdb.com** for additional cross border issues that we commonly see in our practice.

Canadian Trusts:

Even though the Canadian tax advantages of establishing Canadian trusts have declined, we still see many of these trusts in our practice. The problem with Canadian trusts is that lawyers usually prefer settlors that are non-residents of Canada. A big problem can arise if the settlor is a U.S. resident or citizen. The United States taxes the U.S. settlor of a Canadian trust with U.S. beneficiaries as the owner of the trust's assets and therefore, any income earned by the trust is attributed back to the U.S. settlor. As a result, any dividends paid to the trust will be taxable on the U.S. settlor's United States return. Needless to say, this can be quite a surprise for the U.S. settlor.

U.S. Citizens and Canadian Corporations:

U.S. tax legislation includes a variety of punitive sections relating to foreign (e.g. Canadian) corporations with U.S. shareholders. Two of the more common problems that we see are as follows:

1. Unforeseen U.S. tax consequences may result when a U.S. citizen transfers assets into a Canadian corporation under the Canadian tax-free rollover provisions. The biggest problem we see is the general practice on the Canadian side to take back a shareholder loan equal to the cost base of the assets transferred. From a Canadian standpoint, this loan does not affect the tax-free status of the transfer; however, the U.S. considers this loan as boot and taxes it accordingly.

2. Another problem we see is Canadian private corporations not distributing passive types of income on an annual basis to its U.S. citizen shareholders. For U. S. tax purposes, this income may be attributed back to the U.S. citizen shareholder and taxed in the shareholder's hands currently. If this occurs, double taxation may result as the income is taxed on an annual basis in the United States and taxed in Canada upon eventual distribution.

LLC Trap:

U.S. Limited Liability Companies (LLC) are commonly recommended by U.S. lawyers as the preferred method of operating in the United States. An LLC is treated for U.S. tax purposes as a partnership (i.e. flow through entity) and income earned by the LLC is taxed to its shareholders on an annual basis.

The pitfall for the unwary is that Canada does not treat an LLC as a partnership but as a corporation. This dual status can result in unexpected and negative tax consequences.

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For example, double taxation may occur if the LLC is owned directly by an individual and the LLC does not distribute its earnings on an annual basis. Double taxation can result because the U.S. taxes shareholders on their distributive share of the LLC's income while Canada taxes actual distributions from the LLC as a dividend. This mismatching of income can lead to problems in utilizing the U.S. taxes as a foreign tax credit on the Canadian return. In most cases, the negative consequences of investing in a U.S. LLC can be alleviated with proper planning.

Executor Nightmare – A Canadian Estate with U.S. Property

Many individuals have no idea what they are getting themselves into when they agree to act as an executor for a decedent with U.S. situs property. In many cases, property may not be transferred from an estate until the IRS issues a clearance certificate. Unfortunately, the process of obtaining a clearance certificate can drag on for years, especially if the deceased did not attend to the necessary U.S. filings while alive. It is very important that owners of U.S. property address the estate tax consequences associated with their U.S. property before saddling their executors with the headache.

Stock Options

The taxation of stock options has recently become a very hot topic. If your client is a U.S. citizen, or the stock options are issued by a U.S. company, it is imperative that the U.S. and Canadian tax situation be reviewed to ensure the taxes paid to one country are eligible as a foreign tax credit in the other. The general rule with respect to stock options is that any income resulting from the exercise of the option is sourced to the country where the services were provided to earn the option. Unfortunately, this general rule can lead to a variety of tax consequences.

U.S. Alternative Minimum Tax:

In recent years we have seen the U.S. Alternative Minimum Tax (AMT) applies more often than ever before.

In our experience, AMT most often occurs in the following situations:

1. U.S. citizens living in Canada – For AMT purposes, a U.S. citizen's foreign tax credit claim is restricted to 90% of the AMT liability. Therefore, regardless of Canadian taxes paid by the U.S. citizen, a tax of at least 10% of the AMT liability will be due if income is above the AMT exemption amount.
2. Canadian residents disposing of U.S. real estate – AMT applies because there is no AMT exemption amount allowed for gains on the disposition of U.S. real property by non residents of the United States,
3. Canadian residents receiving U.S. stock options from United States companies – the spread between FMV and the exercise price is taxable for AMT purposes in the year of exercise regardless of whether or not the tax is deferred for regular tax purposes. This can lead to a U.S. AMT liability.

Recent Developments:

The U.S. and Canada are once again negotiating a protocol to the Canada-U.S. Tax Convention of 1980. One of the proposals is meant to minimize double taxation of a Canadian emigrant's gains upon departing Canada. Currently, Canada taxes upon departure the accrued gains on property while the United States taxes this same accrued gain when the property is actually disposed of – this often leads to double taxation.

The proposal under consideration is to allow the emigrant to elect to be treated under U.S. law as having disposed and reacquired the property at its fair market value. This provision will ensure a matching of foreign tax credits and alleviate the double taxation problem.

Please remember that the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained.