Cross-Border Tax Insight
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Cross-Border Tax Newsletter

Dear Friends,

I am wishing you all a happy new year. Seems like there is a lot of volatility in the world. Let's hope for peace in 2008. My new year's resolution for 2008 – is to put out this newsletter on a more regular basis now. I have a good excuse – I have been busy studying for a professional exam that I recently wrote. One of my colleague warns me that too much studying may result in stroke. Good to know.

I would like to thank Michael Atlas, CA whom has agreed to contribute an article to this newsletter.

Best,

Joseph Soussan, Editor

THE NEW WORLD OF PRIVATE CORPORATION TAX PLANNING

By Michael I. Atlas

In my view, the Federal "Mini-Budget" that was released at the end of last year will have an extremely dramatic impact on tax planning for private corporations and their shareholders. In fact, the way I see it, more than anything I have witnessed since the dawn of the current tax system in 1972, and it will completely alter the tax planning landscape.

Of course, some of the tax reductions contained therein had been planned previously, but this is more significant and, frankly, I was never counting on them before. Now, I think the feds really mean business, and unless there is a dramatic change in the economy, they will come to fruition.

This newsletter is generally published several times a year. The newsletter is posted to the author's website— www.usatax.ca upon its release. Prior editions are also posted.

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NORTH AMERICAN TAX SERVICES

Cross-Border Tax Insight

Based on the projected tax cuts, even if Ontario maintains a 14% corporate tax rate, we will be looking at a 29% tax rate in 2011 for "full rate" taxable income. If Ontario moves down to 10% as the feds would like, the rate would be 25%. What makes this particularly significant in terms of planning is not the absolute tax rate itself, but the fact that the highest marginal personal tax rate *remains unchanged*! That is, we are still looking at 46.4% in Ontario, a differential of over 17%.

Obviously, the emphasis on tax planning will be to try to capture that rate as opposed to 46.4% wherever possible. Forget about what they do with dividend taxation, and the "GRIP"! Even if the taxation of dividends is increased to take into account lower corporate tax rates, it should not matter if we are looking at LIFETIME tax deferral! That is, if the money is kept in the company to invest throughout the lifetimes of the shareholder and spouse, it will be taxed as a capital gain (on death) in any event, and then can be withdrawn after that tax-free via what I and certain other writers call the "pipeline" technique.

We do not have to wait until 2011 either-even if we look at 2008, we are down to rates of 33.5% versus the prior 36.12%-still a lot less than 46.4% if the client does not need the money in his/her personal hands.

He is what I see in particular:

(a) The case for not bonusing-out high-rate active business income just got even stronger where companies are making mega-bucks. Even with the Ontario clawback, it will still probably make sense, although in 2008, if all the excess income is in the clawback range (which, by the way, was recently raised to income over $500,000), it may be borderline. However, companies that get SR&D tax credits will have to consider any adverse tax consequences of taxable income over $400,000.

(b) What about incorporating employees who are making big bucks? The case for that just got even stronger and will really be appealing as the years go by.

(c) Estate "freezing" of shares in private corporations will become even more significant. As companies leave retained earnings behind, rather than bonusing it out, the value of the shares will increase, even if there is no increase in business value. The freeze will make sense so as to avoid taxation of the accrued capital gain on the death of the current shareholder or spouse and push it into the next generation.

(d) What about moving investment income into corporations to capture that 33.5% rate, going down to 29%? On the face of it, that is impossible-private corporation investment income is taxed at around 49% in Ontario because there is no "general rate reduction", plus there is a 6 2/3% surtax. But what if we have a situation with big enough bucks to warrant sophisticated planning and took steps so that the corporation *was not a CCPC*! Investment income in a private corporation that is not a CCPC would be taxed at the same low rate that ABI would. How do we avoid CCPC status? That should not be that hard to do-we could give enough "just votes" special shares to the shareholder's Aunt in Cincinnati so that she has voting control. Or, if we do not want to involve other family members, we could just have the shareholder(s) here have a corporation formed in a tax-free offshore jurisdiction and have that company hold those voting shares.

Exciting times ahead! The bottom line is: from this point on, any individual who is making serious money that he/she will not likely need to use during their lifetime should be looking at ways to shift such income into a corporation that will pay no more than the general corporate tax rate.

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Focus on Code Sec. 6015 – Taxpayer Allowed to File as Single Person Given Invalid Marriage After filing Jointly – Case Summary Lois Lipton v. Commissioner, T.C. Summary 2007-36 Docket No. 12588-04S . Filed March 7, 2007

By Joseph Soussan

A taxpayer who had participated in a wedding ceremony with a man who was already married, was not entitled to innocent spouse relief with respect to joint returns the couple had filed. Since the marriage was considered legally void, she was not entitled to joint filing status and was not entitled to innocent spouse relief. The taxpayer's liability was thus redetermined using the filing status "single".

This case arose from a petitioner's election to seek relief from joint and several liability for Federal income tax for the taxable year 2001 under section 6015(f). The respondent determined that petitioner was not entitled to such relief. The sole issue before this Court was whether the petitioner qualified for relief under section 6015(f) for 2001 for an underpayment of tax shown on the retur

Facts

At the time that the petition was filed, the petitioner resided in Wilmington, Delaware.

The Petitioner ("Lois") and Mr. Ebrehem Khalil Aly, an Egyptian national, met over the Internet sometime in 1996 and began a romantic relationship soon thereafter that spanned the next 5 years. Ebrehem was married with children and living in Egypt at the time that he began an online relationship with Donna. The relationship culminated in early 2001 when Ebrehem traveled to United States. Shortly after Ebrehem's arrival, Lois and Ebrehem were married by a clerk of the court in Florida.

Ebrehem and Lois left Florida to reside permanently in Delaware, where they both worked at Delcare Management, LLC ("Delcare"), a physical therapy center. Prior to his arrival in the United States, Ebrehem told Lois that he was a physician in Egypt. At Delcare, Mr. Aly assisted with therapy services, while Lois worked as the center's office manager.

Once Ebrehem started to receive paychecks from Delcare, he was successful in having his tax withholdings significantly reduced due to the fact that he had several children back in Eygpt for which he hoped to claim personal exemptions for. Subsequently, Ebrehem was informed that he would not qualify for such dependent personal exemptions, as his children did not meet US residency requirements. At this point, Ebrehem did not bother to change the number of exemptions he had reported to Delcare for withholding purposes.

On June 26, 2002, Lois and Ebrehem filed a 2001 Form 1040, U.S. Individual Income Tax Return. On their 2001 return, they elected the filing status of "married filing jointly." They reported tax due and owing of $10,808 on their 2001 return; however, they failed to make any payment with respect to this tax due. On December 10, 2002, Lois and Aly submitted an offer-in-compromise with respect to the unpaid tax for 2001. Consequently, the IRS rejected the offer-in-compromise and the liability stemming from 2001 tax return remained unpaid.

In 2003, the IRS received from Lois Form 8857, Request for Innocent Spouse Relief, with respect to 2001. In January 2004, an IRS appeals officer sent Lois a notice of determination informing her that she was not entitled to innocent spouse relief for 2001.

Lois was subsequently informed by agents of the Federal Bureau of Investigations (FBI) in January 2003 that Mr. Aly was still married to his wife in Egypt. Lois commenced annulment proceedings[1].

1. Legally such was not required, as the marriage was never considered to be legal in the first place.

Conclusion and Additional Consideration

The tax court held that Lois was not entitled to innocent spouse relief for 2001 because she was not eligible to file a joint return for 2001 in the first place. It then confirmed that her correct filing status should have been single, and that her 2001 tax liability should have originally been calculated using such status.

Specifically, as a general rule, spouses making joint Federal income tax returns are jointly and severally liable for all taxes shown on the return or found to be owing per Sec. 6013(d)(3). In certain situations, however, a joint return filer can avoid such joint and several liability by qualifying for relief there from under section 6015.

Section 6015 provides relief from joint liability by providing the taxpayer with three avenues for obtaining relief: (1) Section 6015(b) provides full or apportioned relief with respect to understatements of tax attributable to certain erroneous items on the return; (2) section 6015(c) provides relief for a portion of an understatement of tax for taxpayers who are separated or divorced; and (3) section 6015(f) confers upon the Secretary discretion to grant equitable relief for taxpayers who otherwise do not qualify for relief under section 6015(b) or (c). As there was no understatement of tax at issue, neither section 6015(b) nor (c) was deemed applicable. Therefore, only equitable relief provisions of section 6015(f). became relevant.

Section 6015(f), as amended, provides, in part, that a taxpayer may be relieved from joint and several liability if it is determined that, taking into account all the facts and circumstances, it is inequitable to hold the taxpayer liable for the unpaid tax, and relief is not available under section 6015(b) or (c). To prevail, the petitioner must prove both that she is entitled to relief under section 6015 and that respondent's denial of equitable relief from joint liability under section 6015(f) was an abuse of discretion (by the IRS).

In order to be eligible for relief under section 6015, a petitioner must have filed a joint return for the taxable year at issue. See sec. 6015(a)(1), (b)(1)(A). Section 6013(1)(a) defines a joint return as that made by a "husband and wife". In the administration of the Federal income tax laws, the marital status of individuals is determined under State law where the taxpayer resides[2]. Accordingly, one must consider the petitioner's and Ebrehem's marital status under Florida law since this was they place where they originally married. Under Florida law, a person who has a living spouse and marries another person is guilty of a felony of the third degree. Any such marriage would be clearly considered void.

In conclusion, Lois was deemed not entitled to relief under section 6015 because she was not eligible to file a joint return for taxable year 2001, as she was not considered legally married. Despite Lois's not obtaining innocent spouse relief, she effectively accomplished the same thing by being able to file as a single person, thereby becoming liable only for tax on her personal income.

2. *Von Tersch v. Commissioner,* 47 T.C. 415, 419 (1967); Rev. Rul. 58-66, 1958-1 C.B. 60

Capital Gain Tax Planning Considerations for US residents – 2007 and Beyond

By Joseph Soussan

For 2007 and through 2010, reduced tax rates for long-term capital gains and "qualified" dividend income may permit planning opportunities for specific taxpayers.

In the past, year-end tax reduction strategies for long-term capital gain and qualified dividend income used to be of real concern only to the high-bracket investor. However, the zero capital gains tax rate for lower bracket taxpayers through 2010, in addition to the possibility of much higher capital gains rates for everyone after 2010, if not earlier, may provide taxpayers with a window of opportunity to reduce capital gains related tax in the next few years.

Basic capital gains planning

Long-term and short-term capital gains and losses are offset against one another to produce a net capital gain or loss. The long-term holding period is more than one year and the short-term holding period is one year or less. Long-term capital losses must first be used to offset long-term capital gains. Moreover, short-term capital losses must first be used to offset short-term capital gains before they can be used to offset long-term capital gains.

An individual may use both net short-term and long-term capital losses to offset up to $3,000 in ordinary income ($1,500 for married individuals who file separately), such as wages, interest or dividends. Individuals and other non-corporate taxpayers can carry forward a net capital loss that exceeds the $3,000 annual limit for an unlimited time until the losses are eventually utilized. A capital loss that is carried forward to a later tax year retains its long-term or short-term character, for the purpose of any offsetting (against a gain) in the current year.

Capital Gains Tax Rates for Various Items 2007-2010

Tax years 2007 through 2010 provide capital gains planning opportunities for many taxpayers. Current tax law provides preferential treatment for long-term capital gains and qualified dividend income. From 2007 through December 31, 2010, dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same tax rates that apply to capital gains. This treatment of "qualified dividends" applies for purposes of both regular tax liability and the AMT. The maximum tax rate is 15 percent for individual and non-corporate taxpayers in the top four tax brackets.

Note that capital gains on collectibles are subject to a maximum rate of 28 percent, while unrecaptured Sec. 1250 gain is subject to a maximum rate of 25 percent. When a taxpayer sells or exchanges certain small business stock (i.e., Sec. 1202 stock) that the taxpayer has held for more than five years, 50% of the gain may be excluded from the taxpayer's gross income. If the small business stock qualifies for this 50% exclusion, any recognized gain from the sale or exchange of the stock is subject to a maximum capital gains rate of 28% (Code Sec. 1(h)(4)(A)(ii)).

For 2007, long-term capital gains and qualified dividends are taxed at five percent for individuals in the 10 and 15 percent tax brackets. From 2008 through 2010, the long-term capital gains rate for such individuals in the 10 and 15 percent tax brackets will drop to **zero-percent**. Note, that both the five-percent and zero-percent tax rates for long-term gains and qualified dividend income applies only to the extent that an individual's adjusted net capital gains would be taxed at 10 or 15 percent rate if such was considered ordinary income.

The 15 and zero percent capital gain tax rates were established in the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. The preferential rates were set to expire after December 31, 2008, but were extended for two years (through December 31, 2010) by the *Tax Increase Prevention Reconciliation Act of 2005 (TIPRA)*. Dividend income qualifies for taxation at capital gains rates if the dividend is received by an individual from a domestic corporation, or a qualified foreign corporation, and a holding period of 60 days is satisfied.

Recognize asset sales before 2011

In conclusion, investors in the 10 and 15 percent tax bracket who are considering the disposition of appreciated long-term assets in the next few years, will want to keep in mind the tax rates as mentioned above. Again, in 2011 expected tax rates may be higher than they are currently. Of course, tax benefits must be considered in conjunction with potential appreciation post 2010 in assuming an overall financial plan. Certainly, no investor wants to lose more capital than potential tax savings.

Long-term losses and short-term gains

An individual with accrued long-term capital losses, but realized short-term capital gains, should also consider realizing such long-term capital losses in a year in which he or she does not have long-term capital gains, but has realized short-term capital gains. Since short-term capital gains and ordinary income do not receive the preferential treatment (i.e. reduced tax rates) that long term capital gains do, realized long-term losses may be used to offset short-term gains, which would otherwise again be subject to a higher tax rate. Obviously, investment considerations must be taken into account, before tax planning is finalized.

Beware of the Wash Sale Rules

Under the wash sale rules, a capital loss incurred upon a sale or other disposition of stock or securities is not allowed if, within a period beginning 30 days before the date of the disposition and ending 30 days after that date, the individual acquired, or entered into a contract or option to acquire, substantially identical stock or securities. This prevents taxpayers from selling stock to establish a tax loss and then buying it back the next day.

Joseph Soussan founded (Toronto based) ***North American Tax Services*** in 1998. Since 1997, he is a member of the Certified General Accountants' Association of Ontario. He completed the CICA In-Depth Tax Course in 2000, and obtained CPA certification in 1998 from the state of Delaware. He is currently a licensed CPA in the state of New Hampshire. Joseph maintains a keen interest in taxation of cross-border investments.

His firm is dedicated to providing both U.S. (primarily) and Canadian tax expertise (as applicable to international tax situations), tax–related educational services, and technical writing assistance to Canadian accounting and law firms. Joseph has lectured for several organizations and companies on cross-border tax matters. Furthermore, Joseph is the author of "*Cross-Border Tax Insight*" – a tax based newsletter that is sent to other tax practitioners in North America and is made available on his website at www.usatax.ca.

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Call Joseph today and find out how he can be of help to your firm or clients!

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