



2011 CANADA-US CROSS BORDER TAX SURVIVAL GUIDE



The UHY Canada-US Tax Team (CUTT) is an active group of tax and accounting professionals with hands-on expertise in assisting clients identify and implement practical solutions to their cross-border tax and business issues.

CUTT is pleased to present this guide, which reviews a number of recent changes affecting cross-border business between Canada and the US.

I thank Abigail Kan, Chuck Sockett, Dennis Petri, Jerry Seade, Sudeep Goyal, Todd Bensley and Aliona Starkova for their contributions and assistance in preparing this document.

Please do not hesitate to contact any of the members listed in the last page of this document if we can be of service to you with your Canada-US cross-border issues.



Chairperson, UHY Canada-US Tax Team
January 2011

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TRANSFER PRICING

Both the Internal Revenue Service (IRS) and Canada Revenue Agency (CRA) announced greater scrutiny including an increase of audits involving cross-border transactions between related parties. Additionally, in recent years tax authorities have selected more small and medium sized businesses for transfer-price audits.

Transfer pricing transactions can be grouped in three general areas:

- Intangible payments, such as royalties.
- Management and administration fees.
- Sale of products.

Both the IRS and CRA require companies to have transfer pricing agreements in place that follow the OECD transfer pricing guidelines. These agreements must provide support of arm's length terms and conditions (including prices), must show reasonable efforts, and must provide complete and accurate description of the transactions.

Tax authorities require that related party non-resident transactions occur at prices that would have been made between persons dealing at arm's length. Penalties can be imposed if a tax adjustment is greater than 10% of gross revenues or \$5 million.

Two transfer pricing decisions were rendered by the Canadian Federal Court of Appeal in 2010, representing the first significant judicial pronouncements in this area for many years.

General Electric Capital Canada v. The Queen

The CRA's position has been that it is not reasonable for a subsidiary to pay fees to its parent in consideration for the parent guaranteeing the subsidiary's debt.

In General Electric, the CRA challenged the deduction of guarantee fees paid by a Canadian subsidiary to its indirect parent. The Federal Court of Appeal affirmed the Tax Court of Canada's decision in favour of the taxpayer.

The Tax Court held that implicit support derived from the related group was a relevant factor that it should consider. In the circumstances under consideration, the benefit received by the Canadian subsidiary from the guarantee exceeded the amount paid by the Canadian subsidiary for the guarantee and accordingly the guarantee fees were deductible.

GlaxoSmithKline Inc. v. The Queen

The taxpayer GlaxoSmithKline packaged and sold Zantac, a patented and trademarked drug, in Canada. The CRA argued that the taxpayer paid an unreasonably high amount for its purchases from a related Swiss company of the active pharmaceutical ingredient in Zantac.

The Zantac trademark and patents were owned by the taxpayer's parent, and were licensed to the taxpayer for use in Canada under a licensing agreement. Under the licensing agreement, the taxpayer was obligated to purchase the ingredient from the related Swiss company. The CRA argued that in the years in question Canadian companies were able to purchase the ingredient for a price less than that paid by the taxpayer, and therefore the transfer price was not at fair market value.

The Federal Court of Appeal reversed the Tax Court's decision because it did not consider all relevant circumstances which an arm's length purchaser would have had to consider, particularly the license agreement with the parent. The Federal Court of Appeal sent the matter back to the Tax Court for reconsideration of a reasonable transfer price taking into account the licensing agreement.



RELINQUISHING OF US CITIZENSHIP

EXPATRIATES

Expatriates are US citizens who relinquish their US citizenship and long-term permanent residents who surrender their green cards.

Taxpayers must file an Exit Return in the year of the renunciation, which triggers a deemed sale of their assets the day before the expatriation date at fair market value and the US tax liability on such gains is in excess of \$600,000. In the case of any taxable year beginning in a calendar year after 2008, the \$600,000 exclusion shall be indexed for inflation.

In general, any additional tax attributable to the deemed sale of property may be extended until the due date of the return for the taxable year in which such property is disposed of provided an election to defer the tax is made. An irrevocable election to defer the tax may be made as long as adequate security is provided. A bond or letters of credit are acceptable security interests. Interest will be charged on any deferral of tax.

Certain property deemed sold will not qualify for the election such as:

- Any deferred compensation payments
- Any specified tax deferred account
- Any interest in a nongrantor trust

Special rules apply to US withholding on deferred compensation payments.

Only “covered expatriates” are subject to the deemed sale rules. A “covered expatriate” is a person whose average annual net income for the 5 tax years ending before the date of loss of US citizenship exceeds \$124,000, the person’s net worth as of such date is \$2,000,000 or more or such person certifies under penalty of perjury that he or she has met the requirements for the 5 preceding taxable years. The \$124,000 shall be indexed for inflation for any calendar year after 2004.

A citizen shall be treated as relinquishing his or her US citizenship on the earliest of:



- Renouncing US nationality before a diplomatic or consular officer of the US pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act.
- Furnishes to the US Department of State a signed statement of voluntary relinquishment of US nationality.
- Date a court of the US cancels a naturalized citizen’s certificate of naturalization.

Note that in 1996 Congress enacted immigration legislation amending the grounds of ineligibility for visas and of inadmissibility to the US. Under that section of the law, known as the “Reed Amendment”, any former US citizen who officially renounces US citizenship and who is determined by the Attorney General to have renounced for the purpose of avoiding taxation by the US is inadmissible to the United States and ineligible for a visa.

HYBRIDS

US LLC'S IN CANADA

In 2010 the Tax Court of Canada ruled that US Limited Liability Company's have access to protection under the US-Canada Tax Treaty (see TD Securities (USA) LLC 2010 TCC 186). Accordingly, US LLC's that paid Canadian Branch Tax at the rate of 25% should consider requesting refunds to adjust the withholdings to the preferential 5% rate under the treaty.

The implications of this ruling reach further than just

branch profits tax. The ruling declares that US LLC's have access to treaty benefits, and therefore these entities can apply for refunds for excess withholding taxes paid for:

- Interest (10% rather than 25%)
- Dividends (5% or 15% rather than 25%)
- Royalty payments (nil or 10% rather than 25%)
- Capital gains (possibly no withholdings required)

CANADIAN ULC'S

Beginning January 1, 2010, Canadian "hybrid" entities are not entitled to treaty benefits, and will be subject to a 25% withholding tax on cross-border payments of interest and dividends. Unlimited liability companies ("ULC's") in Canada include British Columbia, Nova Scotia and

Alberta Unlimited Liability Corporations.

Note that there are techniques that may be available to avoid the denial of US Treaty benefits for certain situations.

WITHHOLDING TAXES

CANADA - REGULATION 102 AND 105

Many US corporations providing services in Canada continue to struggle to comply with Regulation 102 and 105 withholding regulations.

Regulation 105 of the Canadian Income Tax Act imposes a 15% withholding tax on fees, commissions or other amounts earned from services rendered in Canada by non-resident individuals and corporations. If these services are rendered in the province of Quebec, they will be subject to an additional Quebec withholding of 9%.

These amounts must be withheld by the Canadian payor even if the non-resident providing the services has no permanent establishment in Canada.

Often these withholding taxes can be recouped. The non-resident entity must file a Canadian (and Quebec) tax return at the end of the non-resident's fiscal year and claim a refund to the extent permitted on those tax returns.

US WITHHOLDING REQUIREMENTS

The IRS recently hired 2,000 new agents to audit withholdings on payments to non-residents.

Entities making payments to non-residents are required to appoint a holding agent, who is any person having the control, receipt, custody, disposal or payment of specified items of income to the extent it is gross income from US sources.

Generally, withholding taxes are reported on Forms 1042 and 1042-S and filed with the IRS on or before March 15th. In addition, the withholding agent is required to deposit amounts withheld in a US bank.

Reduced Tax Treaty rates on withholdings can be used. A reduction or exemption from US withholding under a Treaty is generally made by filing Form 8233 and is forwarded to the IRS within 5 days of receipt.

Withholding on US taxable income of Partnerships or LLC's - withholding is required by a partnership and LLC with effectively connected income. Forms 8805 and 8813 are used to report the withholding tax.

Interest income may be exempt from withholding tax. New Regulation 102 rules may allow for exemption of payroll withholding requirements.

REAL ESTATE

AMERICANS OWNING RENTAL PROPERTY IN CANADA

Generally, Americans owning Canadian real estate must:

- File Canadian income tax returns annually
- Remit withholdings to the CRA on a monthly basis
- Have withholdings of at least 25% of the gross rental income (withholdings may be reduced to 25% of the projected net income if a section 216 election is filed

in advance)

Americans selling Canadian Real Estate must:

- Remit withholdings of 25% (plus 12% in Quebec where applicable) on the sale of real estate within 10 days of the sale (onerous withholdings can be reduced if a "clearance certificate" is obtained)

CANADIANS OWNING RENTAL PROPERTY IN THE US

Applies to individuals, corporations, partnerships, LLC's, trusts and estates. Canadian real estate investors generally:

- Are not required to file tax returns annually for personal use properties.
- Must apply withholding tax of 10% on amount realized on disposition or sale.
- Are exempt from withholding on a sale if the buyer acquires the US real property for use as a residence and the amount realized does not exceed \$300,000.

The 10% withholding is applicable to the ownership of

US real property held directly by individuals, indirectly through partnerships and ownership of stock in a US corporation which is a US real property holding corporation.

Activities to watch out for:

- Dispositions of US Real Property Interest
- Application of FIRPTA (Foreign Investment in Real Property Tax Act)
- US withholding on dispositions
- How to structure ownership of US vacation properties. Often the use of trusts and partnerships can achieve significant tax savings.

ESTATES AND TRUSTS

US ESTATE TAX

US Estate Tax can apply to US citizens residing in Canada, and Canadian's who own US investments at the time of death.

2010 ended with a two-year extension of the 2001 Bush tax cuts for all individual taxpayers. This legislation set out the US estate tax for 2011 and 2012. The legislation reduces the rate of estate tax for 2011 and 2012 to 35% and sets the exemption at \$5 million (or \$10 million for a married couple).

The legislation also induced the following:

- For 2012, the \$5 million exemption will be adjusted for inflation.
- The gift tax and the generation-skipping transfer tax exemptions are increased to \$5 million; and

- A new election permits the first-to-die spouse to allocate his or her unused exemption to the surviving spouse.

For individuals who died in 2010, the expiration of the estate tax was not repealed, such estates can avoid the estate tax unless the executor elects to be subject to the tax. This may be desirable for smaller estates that can benefit from the basis step-up rules without being subject to a material amount of estate tax.

US individuals also had a once-in-a-lifetime opportunity to transfer assets in 2010 free of generation-skipping tax (although transfers were subject to gift tax if they exceeded the \$1 million credit available in 2010 for inter vivos gifts).

CANADIAN TRUSTS

On November 17, 2010, the long awaited decision was released by the Federal Court of Appeal (“FCA”) in the “Garron Family Trust” case.

In its decision the Court supported the original Tax Court of Canada ruling that the central management and control test is the appropriate one to utilize when determining the residence of a trust for tax purposes. This ruling emphasizes

that the residence of a trust is determined by the location of its the mind and management, rather than its legal form.

We will be following this ruling to see whether or not the taxpayer seeks leave to the Supreme Court of Canada.



MISCELLANEOUS

CHANGE IN “TAXABLE CANADIAN PROPERTY”

The 2010 Canadian budget included a set of amendments to the definition of “Taxable Canadian Property” (“TCP”) which result in the elimination of reporting requirements on the disposition by non-residents of shares.

Shares of an unlisted corporation will now only be TCP if, at any time in the past 60 months, more than 50% of the fair market value of the relevant share was derived from Canadian real property, including real estate, resource properties and timber properties.

Shares of a listed corporation will now only be TCP if at any

time in the previous 60 months, 25% or more of the shares of the corporation were owned by the taxpayer and/or non-arm’s length persons, and more than 50% of the fair market value of the relevant share was derived from Canadian real property, including real estate, resource properties and timber properties.

The changes also mean that the Income Tax Act will exclude the gain from certain shares from Canadian tax, and Americans will no longer have to rely on treaty relief for an exemption from Canadian tax on the disposition of such shares.

PERMANENT ESTABLISHMENT

Effective January 1, 2010 the fifth protocol to the US Canada Tax Treaty introduced a new definition of Permanent Establishment. As a result of this change cross border contractors will be deemed to have a permanent establishment in the other country if either:

Permanent Establishment - The Single Individual Test (for Individuals)

Services are performed by an individual who is present in the other Contracting State for more than 183 days in a

12-month period and, during this period, more than 50% of the gross active revenues of the enterprise are generated from these services; or

Permanent Establishment - The Enterprise Test (for Corporations)

Services are provided in the other Contracting State for more than 183 days in a 12-month period with respect to the same or connected project for a customer’s PE in the other Contracting State.

LATE FILING PENALTIES

The Canadian Federal Court of Appeal ruled (see Exida.com Limited Liability Company v. The Queen, 2010 DTC 5101) that the penalty for late filing of a tax return was not limited to whether taxes are owing on a return. Accordingly, now a late-filing penalty on a tax return can be imposed even when no taxes may be owed. This ruling could effect:

- US entities carrying on a business in Canada through a branch.
- US entities disposing of Taxable Canadian Property.

The penalty for late filing a tax return is \$2,500/year.

HARMONIZED SALES TAX IN ONTARIO AND BRITISH COLUMBIA

The provinces of British Columbia and Ontario harmonized their provincial retail sales taxes with the federal Goods and Services Tax ("GST") to create a Harmonized Sales Tax ("HST"). Accordingly, the HST is now set at 12% in British Columbia and 13% in Ontario. As a result of this change, more US supplies will be subject to Canadian Sales Tax, which can include services and lease payments.

New Place of Supply Rules for determining whether a supply is made in a province were introduced in 2010 and apply to any supply made on or after May 1, 2010 (February 25, 2010 if the amount for the supply has not become payable, and has not been paid, before May 1, 2010).

There are a number of significant changes to the supplies for services, meaning the portion of the service that is performed in Canada. The rules for supplies of services are generally based on the business address of the customer. However there are exceptions for certain services, which include:

- Personal services
- Services in relation to real property, goods or a location-specific event
- Services rendered in connection with litigation
- Customs brokerage services
- Computer-related services and internet access
- Repairs, maintenance, and photographic-related goods.

There is no change to the place of supplies of real property and goods by way of sale.

A supply of real property is considered to be made in a province (and in Canada) and therefore is subject to the GST/HST rate of that province if the property is situated in the province. A supply by way of sale of good is deemed to be made in a province if the supplier (legally) delivers the property or makes it available in the province to the recipient of the supply.

US PASSIVE FOREIGN INVESTMENT CORPORATIONS ("PFIC") RULES

The 2010 Hire Act requires that each PFIC shareholder file an annual report containing any information required by the IRS for entities for tax years beginning before March 18, 2010. It is not yet clear what information will be required in the

annual report. These reporting requirements are in addition to the existing requirement to complete form 8631, which is included with a shareholder's tax return.

OTHER US REPORTING ISSUES

5471 – Information Return of US Person with respect to certain foreign Corporations. Failure to file a complete and accurate Form is subject to a \$10,000 civil penalty, per filing.

5472 – Information of a 25% foreign-owned US Corporation or Foreign Corporation engaged in a US trade or business. Failure to file a complete and accurate Form is subject to a \$10,000 civil penalty, per filing.

FBAR-TD F 90-22.1 – Information detailing foreign bank accounts and other foreign investments. Failure to properly file the Form may be subject to a civil penalty not to exceed \$10,000. Reasonable cause for failure to file may eliminate the penalty. Willful failure to file may be subject to a civil

monetary penalty equal to the greater of \$100,000 or 50% of the balance in the account.

Withholding - 1042, 1042-S – Failure to file the Form is subject to a \$100 penalty for each filing. Failure to withhold subjects the withholding agent for personal liability for the tax and interest on the unpaid tax.

Form 1120F – Required if a foreign corporation conducts business in the U.S (whether or not through a US office), and its US tax was not satisfied through withholding or is claiming tax treaty benefits. Failure to file Form 1120F may result in the income of the foreign corporation to be taxed on a gross basis.

OTHER CANADIAN REPORTING ISSUES

T1134 – Foreign Affiliate Reporting: Taxpayers are required to file T1134A and T1134B information returns annually to report information regarding their foreign affiliates and controlled foreign affiliates respectively. In very general terms, a foreign affiliate is a non-resident corporation in which the taxpayer has at least 1% direct ownership and 10% indirect ownership. These returns are required to be filed no later than 15 months following the taxpayer's taxation year end. Assuming that the taxpayer is not required to file more than 50 T1134 returns, the maximum late-filing penalty with respect to T1134 returns is \$1,000.

T106 – Reporting Non-Arm's Length Transactions with Non-Residents: Taxpayers are required to report their transactions with non-arm's length non-residents for each taxation year by filing a T106 information return if the combined annual amount of these transactions exceeds \$1,000,000. Common reportable transactions include sales, purchases, and borrowing and repayments of loans and indebtedness. These forms are required to be filed by the filing deadline for the taxpayer's income tax return for the year. Assuming that the taxpayer is not required to file more than 50 T106 slips, the maximum late-filing penalty with respect to T106 forms is \$1,000.

T1135 – Foreign Property Reporting: Canadian resident taxpayers that own foreign property with cost in excess of \$100,000 at any point during a year are required to file a T1135 information return with the CRA to report certain information regarding the foreign property and income derived from the foreign property. This form is required to be filed by the taxpayer's deadline for filing its income tax return for the year. The maximum penalty for late-filing is \$1,000.

T4A-NR – Payments to Non-Residents for Services Performed in Canada: Taxpayers that make payments during the calendar year to non-residents for services performed in Canada are required to file a T4A-NR information return with the CRA for the year. A T4A-NR return reports both the gross payments made to non-residents and the withholding tax remitted to the CRA with respect to these payments. The filing deadline for T4A-NR information returns is the last day of February of the following calendar year. The maximum penalty for late-filing a T4A-NR information return varies from \$1,000 - \$7,500 depending upon the number of T4A-NR slips required to be filed.

NR4 – Other Payments to Non-Residents: Canadian residents (for this purpose non-residents that carry on business in Canada are deemed to be Canadian residents) are required to file an annual NR4 information return to report other payments made to non-residents during the year. Common payments which are required to be reported on an NR4 return include interest, dividends, and rents. A NR4 return reports both the gross payments made and any withholding tax remitted to the CRA with respect to the payments. The filing deadline for NR4 returns is 90 days after the calendar year end. The maximum penalty for late-filing a NR4 return varies between \$1,000 and \$7,500 depending upon the number of NR4 slips that are required to be filed.

NR6 – Undertaking to Withhold on a Net Basis from Rental Income Paid to Non-Residents: The default Canadian income tax treatment for rents earned in Canada by non-residents is a 25% withholding tax on gross rents. Non-residents may elect to pay Canadian income tax on rental income on a net basis by filing an annual Section 216 election return with the CRA. In order to withhold on a net basis non-residents (together with their Canadian resident agents) must annually file Form NR6 with the CRA. Form NR6 is required to be filed before the first rental payment of the year and must be approved by the CRA prior to withholding on a net basis.

T2 Schedules 91 & 97 – Treaty-Exempt Income Tax Return for Non-Resident Corporations: Non-resident corporations that carry on business in Canada but do not have a permanent establishment in Canada under the applicable bilateral income tax treaty are required to file an annual corporate income tax return (T2) to report their claim for a treaty-based exemption from Canadian income tax. The filing deadline for filing a corporate income tax return is six months after the corporation's fiscal year end. The maximum penalty for late-filing a corporate income tax return is \$2,500.

T5018 – Construction Industry Subcontractor Payment Reporting: Taxpayers that carry on business in the construction industry are required to annually report to the CRA payments made to subcontractors during the year by filing a T5018 information return. Taxpayers can choose to use either the calendar year or their fiscal year to report these payments. The maximum penalty for late-filing a T5018 return varies from \$1,000 - \$7,500 depending upon the number of T5018 slips required.



Solving your cross-border tax issues.

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