SELECTED ISSUES FOR CANADIANS HOLDING AND DISPOSING OF U.S VACATION PROPERTY

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Introduction

For many Canadians (retired and otherwise) winter may be a season best enjoyed in short bursts or avoided altogether. Unfortunately, Canada's majestic beauty notwithstanding, the country is distinctly lacking in locales able to facilitate this preference for milder climate. For this and

many other reasons, many Canadians consider purchasing United States ("U.S.") vacation properties or inherit them from relatives. While the weather may be better down south (or at least in parts of it), there are complexities under the *Income Tax Act* (Canada)[1], the U.S. *Internal Revenue Code*[2], and the Canada-US Tax Treaty[3] in relation to Canadians holding U.S. vacation properties which are often considered too late or not at all. The goal of this paper is to help tax practitioners identify methods to address certain tax complexities surrounding U.S. vacation properties owned by Canadians. In order to achieve this goal, this paper is structured as a series of case studies which reflect scenarios which we have seen in practice and which we believe are likely to be encountered by other practitioners. The first section of this paper provides an introduction to relevant U.S. tax issues relating to non-resident aliens owning U.S. real property.

U.S. Tax Issues for Canadians Owning U.S. Vacation Property

Introduction

The U.S. federal[4] taxation system taxes the transfer of assets during life or upon the death of a taxpayer, primarily via income, gift, estate and generation-skipping transfer tax rules. (U.S. gift, estate and generation-skipping transfer taxes are collectively referred to as "transfer taxes".) Persons who are "non-resident aliens" ("NRAs") of the United States generally are only subject to U.S. tax regimes to the extent the NRA owns (directly or indirectly) U.S. situs assets. NRAs are individuals who are not "U.S. Persons", e.g., individuals who are not U.S. citizens or U.S. tax residents.[5]

Many Canadians own (or want to own) U.S. vacation property. There are several U.S. tax problems that can arise for such Canadians, as will be discussed in the case studies. The following discusses in more technical terms the basic operation of the U.S. tax system as it may affect Canadians owning U.S. real property.

U.S. Federal Income Tax

Introduction

U.S. federal income tax is generally implicated for an NRA owning U.S. real property only when the NRA sells the property, or receives income from the property such as rents. Property taxes and the like may, of course, be imposed on an ongoing basis. Those types of taxes are not discussed herein.

Sale

U.S. federal income tax may be imposed on real estate dispositions by an NRA involving: (a) a sale by a NRA individual, (b) a sale by a non-U.S. ("foreign") corporation, (c) a distribution in kind by a foreign corporation to the shareholder, (d) a sale by a foreign trust or estate, (e) a

distribution or sale by a domestic or foreign partnership and (f) in certain cases, a disposition of shares in a U.S. corporation or interest in a U.S. or foreign partnership.

Gain on the sale of U.S. real estate (or other types of "U.S. real property interests" ("USRPI"), such as an interest in a partnership owning U.S. real property) by an NRA is taxed as if the NRA were engaged in a trade or business within the U.S. and as if the gain were connected with that trade or business (typically referred to as "effectively connected income" or "ECI").[6] Such gains are generally taxed the same way they are for a U.S. Person, and most typically for non-commercial real property such as a vacation home or personal residence, the gain (or loss) produced on disposition is capital in nature. The present maximum federal long-term capital gains tax rate is 20 percent for taxpayers that are individuals, trusts and estates which have owned the real property for more than one year.[7]

The 1980 U.S. Foreign Investment in Real Property Tax Act ("FIRPTA")[8] imposes a U.S. withholding tax obligation on the buyer, when a NRA disposes of a U.S. real property interest.[9] Under FIRPTA, with very limited exceptions, buyers purchasing U.S. real property from a NRA are required to withhold 10 percent of the purchase price and remit that amount to the IRS. If the buyer fails to withhold or remit, she may be liable for the tax. Amounts to be withheld under FIRPTA can, however, be adjusted in accordance with a reduced rate withholding certificate issued by the Internal Revenue Service ("IRS") if the actual U.S. tax owing on the sale would be less than the withholding tax. A distribution by a foreign corporation of a USRPI is subject to FIRPTA withholding tax on 35% of the gain.

An NRA individual who sells a USRPI is required to file Form 1040NR (a foreign corporation files Form 1120F) to report the gain on the sale, and either pay additional tax if the FIRPTA withholding did not sufficiently cover the U.S. tax liability, or claim a refund if the FIRPTA withholding was in excess of the actual U.S. tax liability.

Rental

Rental income generated by U.S. real property owned by an NRA is generally taxed at a flat U.S. federal withholding tax rate of 30% on the gross rents, unless the income is ECI.[10] A NRA may elect to treat all income from real property located in the U.S. as ECI.[11]

An advantage to making the ECI election is that certain tax deductions become available, such as depreciation, maintenance costs and property taxes. (Unlike in the Canadian tax system, depreciation must be claimed.) Moreover, as a result of the election, the graduated rates under the Code apply to the taxable income from the rental property as opposed to a flat 30% withholding tax. If the U.S. real property is used both personally and rented to others, however, there may be limitations on deductions under Section 280A of the Code. Such restrictions are outside the scope of this discussion.

U.S. Transfer Tax System[12]

Generally

The U.S. transfer tax system for NRAs is based on the same concepts and structure as the U.S. transfer tax system for U.S. Persons, although an NRA is subject to tax on U.S. situs property only.[13] Therefore, the following sections describe the U.S. transfer tax system generally applicable to U.S. Persons, and how those rules apply to an NRA decedent. In an important distinction for NRAs, the U.S. estate tax applies to much broader categories of U.S. assets than does the U.S. gift tax.

Gift Tax

Although a U.S. person is subject to U.S. gift tax on the gratuitous transfer of property wherever it is located, U.S. gift tax only applies to NRAs on a limited range of property deemed "situated" in the U.S. ("U.S. situs property").[14] Generally, only tangible personal property located in the U.S. or real property located in the U.S. is considered U.S. situs property for purposes of the U.S. gift tax applicable to NRAs.[15] Therefore, any Canadian owning or considering owning U.S. real estate may be exposed to U.S. gift tax on a transfer of such property, including to a spouse. Adding a family member (or anyone else) to title to the U.S. real property as a co-owner is a gift unless consideration is paid.

There are several exclusions, deductions, exemptions and credits that may reduce or eliminate U.S. gift tax. Noted below are those most relevant to a NRA, although this is not an exhaustive list. As will be indicated, however, there often are significant limitations on these benefits in the case of NRAs as compared to U.S. Persons.

Although for a NRA the definition of U.S. situs assets for U.S. gift tax purposes is limited to only two types of property, because the deductions and exclusions are much more limited for a NRA, U.S. gift tax, if it does apply, can be onerous. Therefore, NRAs should be very careful about making gratuitous transfers of tangible personal and real property located in the United States.

A gift does not create an income tax event for U.S. tax purposes. For this reason, a donee has a "carryover" basis in the gifted item, e.g., there is no increase in the gifted item's tax basis.[16] This is different than Canadian tax treatment in some circumstances, and therefore a later sale of the U.S. property by a Canadian donee may result in a mismatch on taxation.

Annual Gift Tax Exclusion

The Code provides a yearly exclusion for gifts. Under this exclusion, the first U.S.14,000.00 (in 2015) of gifts made to any person during the calendar year will not incur gift tax.[17] However, to qualify for the exclusion, gifts generally must be of a "present interest" (as opposed to a "future

interest”). Thus, gifts made in trust need to meet certain additional requirements to qualify as gifts of a present interest.

Charitable Gifts

A U.S. Person’s gifts made to qualifying charitable organizations qualify for a U.S. gift tax deduction, even if the organization is foreign.[18] A charitable gift made by a NRA is deductible, however, only if made to a U.S. charitable organization.[19]

Marital Gifts

A deduction equal to the full value of a spousal gift generally is permitted in transfers of property between spouses.[20] However, the deduction is denied where the donee spouse of the donor is not a U.S. citizen (regardless of whether the donor spouse is a U.S. citizen or U.S. resident).[21] Instead, an increased annual exclusion of U.S. $147,000 (for 2015) is allowed for transfers to a non-citizen spouse.[22] This exclusion is available as long as the transfer is made in a way that would qualify for the marital gift tax deduction if the donee spouse were a U.S. citizen.[23] Generally, this means the gift must be outright.

Gift Tax Unified Credit

The tax on a gift made by a U.S. Person generally is reduced by an applicable unified credit amount (less any credit previously allocated to transfers in prior calendar years).[24] NRAs, however, do not qualify for a unified credit for U.S. gift tax purposes.[25] This lack of availability of a unified credit for taxable gifts made by NRAs has not been altered by any Treaty provision, unlike with the U.S. estate tax.

Estate Tax

Introduction

The U.S. imposes a federal estate tax on the transfer of assets owned or deemed owned by a decedent who is a U.S. Person, regardless of where such assets are located.[26] Assets “owned by the decedent” are very broadly defined, as described below. The U.S. estate tax, like the U.S. gift tax, is based on the value of the property owned, not on the appreciation in the property. Thus, although the range of assets to which U.S. estate tax may apply may be much narrower for a Canadian NRA than the decedent’s worldwide assets to which the Canadian tax at death applies, the base on which the U.S. estate tax is applied is quite broad as compared to the tax base on which the Canadian tax is applied.

The U.S. also imposes a federal estate tax on the taxable estate of a NRA who owns property “situated in the United States” at the time of his or her death if such property would otherwise be includible in such individual’s gross estate had he been a U.S. person.[27] The definition of U.S.

situs property is broader for estate tax purposes than for gift tax purposes.[28] There are several categories of U.S. situs property for U.S. estate tax purposes, including:

tangible personal property located in the U.S.;

real property located in the U.S.;

stocks issued by U.S. corporations; and

debt obligations of U.S. persons (other than certain types of portfolio debt obligations issued after July 19, 1984), including items like deferred compensation or pension arrangements (e.g., 401(k)) of U.S. companies.

Certain assets that seem as though they fit within the broad groupings above are not considered U.S. situs for U.S. estate tax purposes, such as amounts on deposit in U.S. banks (unless connected with a U.S. business)[29] and the death benefit paid on U.S.-issued life insurance contracts.[30]

It is uncertain whether partnership or limited liability company interests, where the entity owns U.S. situs property, would be considered U.S. situs (although the IRS would likely assert these entity interests are U.S. situs for U.S. estate tax purposes).

U.S. situs property owned in a trust in which the decedent had a broad type of power or to which the decedent had made a transfer and retained an interest is also subject to U.S. estate tax exposure. Oddly, according to the Code, a trust like this in which U.S. situs property was owned still remains a U.S. situs asset even if the U.S. situs property is sold before death![31]

As with the U.S. gift tax, certain deductions and credits may reduce or eliminate estate tax for a NRA.

Determining the Gross Estate

The first step in determining the amount of estate tax imposed upon a transfer taking place at death is to establish the value of the decedent's gross estate.[32] The estate tax of a NRA is determined much the same way as the estate tax of a U.S. Person.

Generally, the gross estate of a U.S. Person includes the value of all property to the extent of which the decedent had an interest at the time of his or her death.[33] Property that may be included in a decedent's gross estate for federal estate tax purposes (but may or may not be included in the decedent's probate estate, for local purposes) includes the types of property Canada taxes at death, and also: (a) property transferred during the decedent's lifetime without adequate consideration in which he retained an interest or power[34], (b) property that is jointly held by the decedent with others,[35] (c) property over which the decedent had a general power of appointment,[36] (d) the proceeds of certain insurance policies covering the decedent's life in which he had an interest,[37] and (e) annuities.[38] As noted previously, for a NRA decedent the

gross estate only includes U.S. situs property, not worldwide assets. The NRA decedent's worldwide assets are relevant in determining the allowable amount of certain deductions and credits, however, so this concept of what is considered "in the estate" is relevant for the estate of a NRA with U.S. situs property.

Determining the Taxable Estate

Once the value of a decedent's gross estate is determined, the next step is to determine the value of his or her taxable estate, by subtracting the amount of allowable deductions from the value of the gross estate.[39] Deductions allowed to the estate of a U.S. Person include: estate administration expenses, indebtedness of the decedent, taxes owing by the decedent, losses, charitable transfers, and transfers to a surviving spouse.[40] There are, however, additional limits and restrictions imposed on allowable deductions where the decedent (or, for purposes of the marital deduction, the decedent's spouse) is a NRA. The following list summarizes certain of these additional restrictions.

Expenses, Losses, Debts and Taxes

Deductions for expenses, indebtedness, taxes and losses are allowed to a certain extent for the estate of a NRA decedent. The deductions allowed are based on the proportion of the value of U.S. situs assets to the value of worldwide assets of the decedent.[41] For example, assume the decedent's estate has expenses of $100K, and the decedent had $1M of U.S. situs assets and $10M total assets. In that case, 1/10 (10%) of the estate's expenses would be allowed as a deduction from the U.S. gross estate, or U.S. $10,000. Whether the amounts to be deducted were incurred or expended in the U.S. is irrelevant.[42] The decedent's entire gross estate (e.g., the value of his or her worldwide assets) must be disclosed on the estate tax return for these deductions to be allowed.[43] Note that "worldwide assets" include all assets that constitute the worldwide estate of a U.S. Person and thus include property Canada may not tax at death, such as cash, the principal residence, and the death benefit of life insurance on the decedent's life if the decedent owned an interest in the life insurance policy at his or her death.

Charitable Bequests

An estate tax deduction is allowed for certain bequests made by NRAs to U.S. charitable organizations. In a reversal of a prior rule, U.S. situs assets of a NRA left to a Canadian charity do not qualify for a charitable deduction in the NRA's estate.[44]

Marital Bequests

An unlimited marital deduction generally is allowed for transfers at death to a surviving spouse as long as the surviving spouse is a U.S. citizen.[45] The deduction amount is equal to the value of the interest in property being transferred to a surviving spouse, as long as the spouse is bequeathed the property outright or in certain types of trusts. The typical trust used for a spousal

transfer is one for which a “qualified terminable interest property” (“QTIP”) election is made. A QTIP trust must meet certain restrictions, including that the surviving spouse must be the only beneficiary during his or her lifetime and she must be entitled to all income (payable at least annually).[46] However, the deduction is only allowable where the surviving spouse is a U.S. citizen, unless a trust with special terms is used to receive the bequest, known as a qualified domestic trust (“QDOT”).[47]

A QDOT can be created by (a) the decedent (during life or by Will), (b) the surviving spouse or (c) the executor of the decedent’s estate.[48] There are numerous requirements for a QDOT that are beyond the scope of this paper. Suffice to say, however, that a QDOT can be a burdensome vehicle for a NRA surviving spouse.

Determining Available Credits Against Tentative U.S. Estate Tax

The value of the taxable estate is ascertained by subtracting allowable deductions from the value of the decedent’s gross estate.[49] The taxable estate is then subject to a tentative estate tax.[50] Once the tentative tax is determined, the amount of tax is reduced by any applicable credits. Credits that are potentially available include the following credits.

Unified Credit

An estate tax “unified credit” is allowed to the estate of every decedent.[51] The unified credit in 2015 provides an effective exemption for a U.S. Person of U.S. $5,430,000. The amount is subject to an annual inflation adjustment.

The unified credit amount is reduced with respect to estates of NRAs. The credit amount allowed under the Code against the estate tax imposed on the estate of a NRA decedent is only U.S. $13,000, which exempts U.S. $60,000 of U.S. situs property from U.S. estate tax.[52] Under the Treaty, however, the Canadian decedent’s estate is eligible for a “pro-rated” unified credit equal to the credit allowable to a U.S. Person, multiplied by the ratio of the value of the decedent’s U.S. estate to the value of his or her worldwide estate.[53] This “pro-rated unified credit” is further discussed below.

Marital Credit Under the Treaty

Canadians may also qualify for a marital credit under the Treaty to reduce the U.S. estate tax, if a Canadian decedent leaves his or her U.S. situs property in a manner that would qualify for the marital deduction if the surviving spouse were a U.S. citizen. The marital credit results in essentially a “doubling” of the pro-rated unified credit, and is discussed more below.[54]

Other Credits

The Code provides a certain credit for state death taxes, and for estate taxes paid on property that had been taxed in a prior estate within a certain period of time (which is a credit available to estates of NRAs with certain additional restrictions).[55]

The Effect of U.S. Transfer Taxes on Canadians

Certain U.S. treaties may affect the amount of transfer tax that is imposed on NRAs. The Treaty in fact does offer some relief to Canadians with respect to U.S. transfer taxes. For decades, the Treaty did not provide any rules with respect to such taxes. However, the Treaty now includes Article XXIXB, which addresses taxes imposed by reason of death. The Treaty, however, contains no provisions with respect to U.S. gift tax. The following provisions of the Treaty provide additional relief to Canadians than those provided to NRAs under the Code.

Pro-Rated Unified Credit

As previously explained, the estate of a U.S. Person is allowed a unified credit against estate tax, which for 2015 equates to an exemption equivalent from estate tax for assets not in excess of U.S. $5,430,000.[56] NRAs under the Code are only allowed a $13,000 unified credit, which only exempts U.S. $60,000 of U.S. situs assets from estate tax.[57] The Treaty may increase the amount of the unified credit for estates of Canadians who are not U.S. citizens nor U.S. residents.[58] Under the Treaty, the estates of Canadian residents may obtain a unified credit equal to the greater of: (a) the amount that bears the same ratio to the credit allowed for U.S. Persons as the value of the decedent's U.S. estate bears to the value of his or her worldwide estate or (b) the unified credit allowed under the Code. For example, if a Canadian dies in 2015 with a worldwide estate of U.S. $10,000,000, and U.S. $1,000,000 of such assets are U.S. situs, the pro-rated unified credit provides an exemption equivalent from estate tax equal to 10% x U.S. $5,430,000, or U.S. $543,000. The unified credit under the Code would have exempted only U.S. $60,000 of assets from U.S. estate tax.

As noted above, the assets deemed a part of the worldwide estate are quite broad, so without proper planning the amount of the pro-rated unified credit could be significantly less than anticipated. For example, if the NRA has an estate of U.S. $5,000,000 as determined under Canadian rules, but owned a policy on his or her life with a U.S. $3,000,000 death benefit, his or her worldwide estate is U.S. $8,000,000 for purposes of determining how much of the pro-rated unified credit is available.

Marital Credit

The Treaty provides that a marital credit may be available in addition to the unified credit.[59] The marital credit is available provided that (a) the individual was a U.S. citizen at the time of death

or a resident of either Canada or the U.S., (b) the surviving spouse was a resident of either Canada or the U.S. at the time of the individual's death, and (c) both the individual and the surviving spouse were U.S. residents at the time of the individual's death or one or both was a Canadian citizen. In order to be allowed the marital credit, the executor of the decedent's estate must make an election with the estate tax return and waive the benefits of any estate tax marital deduction that would be allowed under the U.S. tax law, meaning that a QDOT is not available if the marital credit is elected. Moreover, to be eligible for the marital credit, the U.S. property must pass to the surviving spouse in a way that would qualify for the estate tax marital deduction if the surviving spouse were a U.S. citizen and all applicable elections had been properly made. The amount of the marital credit is equal to the amount of the pro-rated unified credit.

Credit for Canadian Tax

To provide symmetry to the estate tax relief granted to Canadians, the Treaty provides that taxes imposed by Canada at death are treated as a "foreign death tax" and, as such, a credit may be allowed for them against the U.S. estate tax imposed on estates of U.S. Persons. The credit is restricted, in practical application, to the extent of the U.S. estate tax arising on the decedent's Canadian property, and only a U.S. Person would be subject to U.S. estate tax on such property.[60] Thus, the estates of U.S. Persons may claim a credit against U.S. estate tax for Canadian tax incurred at death.

Deduction for U.S. Estate Tax

The Treaty provides that estates of Canadian residents may take a deduction against Canadian federal income tax for U.S. estate tax payable on property situated in the United States.[61] This is a very helpful provision for Canadians who die owning U.S. real property, because the U.S. estate tax may significantly reduce or even eliminate, as a practical matter, the Canadian federal income tax at death on such property.

Canadian Spousal Rollover Trust

As explained in the discussion above, under the Code a U.S. estate tax marital deduction may be elected for a transfer to a non-U.S. citizen spouse only if the property passes to a QDOT. Because a QDOT requires at least one U.S. trustee, this may preclude the trust from qualifying as a "Canadian resident trust." In that case, Canadian spousal rollover treatment would not be available. The Treaty provides a solution for this problem. Under the Treaty, a QDOT can make a competent authority request to be treated as a Canadian resident for the purposes of the Canadian Act.[62]

Charitable Transfers

Charitable transfers by a NRA to non-U.S. charitable organizations do not qualify for a charitable deduction from gift or estate taxes.[63]

Conclusion

In summary, the Treaty provides estates of Canadian citizens and residents who are not U.S. Persons a number of tax advantages that would not otherwise exist under the Code. Nevertheless, the Treaty does not fully put Canadians on par with U.S. Persons. One of the areas not covered by the Treaty is the taxation of lifetime gifts. In addition, Canadian residents still have to follow the QDOT requirements under the Code in order to defer U.S. estate tax under the Code for transfers to non-U.S. citizen surviving spouses.[64] The marital credit may obviate the need to form a QDOT, however, if the marital credit would significantly reduce or eliminate U.S. estate tax.

Canadians owning U.S. situs property should carefully consider whether claiming Treaty benefits would be helpful in a given situation. For instance, if an individual's U.S. property is transferred to a surviving spouse and such property does not qualify for rollover treatment in Canada (and is thus taxed at the first spouse's death), it is likely preferable not to make an election for the U.S. marital deduction, but rather to incur U.S. transfer tax in order to obtain an offsetting credit under the Treaty. If the Canadian tax can be postponed, on the other hand, then it is likely preferable to postpone the U.S. estate tax until the surviving spouse's death as well. Note that in order to claim a benefit under the Treaty, an election must be made by the decedent's estate, which means a U.S. estate tax return (IRS Form 706NA) must be filed by the NRA's estate.

Specific Approaches For Owning U.S. Vacation Property by Canadians

There are a number of different ways for Canadians to own U.S. vacation property and each form of ownership poses different issues. The ownership options include sole ownership, joint tenancy with right of survivorship, tenancy in common or a Canadian resident *inter vivos* trust. Ownership by a single purpose corporation incorporated in Canada is no longer advisable. However, this ownership structure still exists because of earlier planning which has been grandfathered pursuant to the administrative position of the Canada Revenue Agency ("CRA"). This paper looks at three specific examples, which are not exhaustive of all the approaches used to own U.S. vacation property.

Case Study One

Introduction

Now that some general understanding of the applicable U.S. law has been provided, we can delve into our first case study, which addresses simple ownership of a Florida residential property by spouses as joint tenants by right of survivorship. This relatively simple scenario (perhaps surprisingly) nonetheless raises a number of technical issues.

The Facts

Mr. Roberts (who resided in Ontario and was not a U.S. person) purchased a residential property in Florida in September, 2005 for U.S. $500,000.00 (Cdn $592,850.00) as a joint tenant by right of survivorship with his wife Mrs. Roberts. However, all the funds were derived exclusively from Mr. Roberts. Mr. Roberts died in 2012 and had worldwide assets of U.S. $5,000,000.00. Mrs. Roberts received the property by operation of law in 2012 by virtue of the right of survivorship. Pursuant to subsection 70(6) of the Canadian Act, Mrs. Roberts inherited the Florida property at its tax cost. It is now September, 2015 and Mrs. Roberts (who resided in Ontario and was not a U.S. person) has passed away. The property is now worth U.S. $800,000 (Cdn $1,054,320.00). Her worldwide assets totaled at her death U.S. $8,000,000.00.

Canadian Tax Law Issues

From a Canadian perspective, on the death of Mrs. Roberts pursuant to subsection 70(5) of the Canadian Act, Mrs. Roberts was deemed to have disposed of each of her capital properties immediately before her death for proceeds equal to their fair market value. The difference between the proceeds of disposition to Mrs. Roberts and the adjusted cost base to her of the Florida residential property will result in a capital gain to her (in this case such gain being Cdn $461,470.00). The Federal and Ontario tax arising as a result of such gain assuming the top marginal rates are applicable would be Cdn $114,260.00 (rounded to a whole number) (Federal rate: 29% and Ontario rate: 20.53%, applicable to the taxable capital gain). Paragraph 6 of Article XXIXB of the Treaty allows the estate to claim a tax credit for the U.S. estate tax against Canadian federal income tax arising in the year of death in respect of the deemed capital gain. The federal tax will be reduced by the U.S. estate tax. However, there is no credit for the U.S. estate tax against Ontario provincial tax.[65]

U.S. Tax Law Issues

Ownership of U.S. real property by NRAs as joint tenants with right of survivorship (or as is sometimes used with married couples, “husband and wife” or “tenancy by the entirety”) generally is not a good form of ownership for U.S. estate tax purposes. This is because when the first owner dies, the presumption is that the full value is included in his or her estate, unless the presumption can be rebutted by showing that the surviving owner contributed to the purchase of the property. Then, when the surviving owner dies, there is full inclusion of the value of the property in the estate for purposes of U.S. estate tax, which can result in paying U.S. estate tax twice on the same property.

At the time of Mr. Roberts’ death the pro-rated estate tax exemption available to Canadians under the Treaty would have been sufficient to shelter his estate from actual payment of U.S. estate tax, even if 100% of the value of the property were in his estate. However, his estate should have filed IRS Form 706NA to report the ownership of the U.S. property and to claim the pro-rated unified credit under the Treaty, which is the mechanism that allows Mr. Roberts’ estate to be exempt from U.S. estate taxation.

While Mr. Roberts' estate could escape U.S. estate taxation on the U.S. real property, that is a fortuitous but unplanned result. If his worldwide estate had been larger, or the exemption amount smaller, there could have been U.S. estate tax at his death.

It should be noted that a joint tenancy with a right of survivorship makes it much more difficult to defer estate tax when the first spousal tenant dies, if U.S. estate tax would arise, because the interest passing to the surviving spousal tenant is not in a form that qualifies for the martial deduction, e.g., it is not a QDOT. The marital credit may be available, but that may not provide complete shelter from U.S. estate tax. If that is the case, and deferral is desired, a post-mortem QDOT would need to be created. This involves significant cost and complexity.

Upon the death of Mrs. Roberts, the full value of the property is included in her estate and, because the value of her worldwide estate is in excess of the exemption amount, there will be U.S. estate tax. Using the pro-rated exemption, there should be U.S. estate tax of approximately U.S. $56,000.00 (Cdn $73,802.40) owing as a consequence of Mrs. Roberts' death. As noted above, the U.S. estate tax can be credited against the Canadian federal tax at death, pursuant to the Treaty, but this may provide limited help in reducing double taxation.

Planning Options/Comments

On an aggregate basis the estate of Mrs. Roberts' total Canadian and US tax exposure in relation to the Florida residential property as a result of her death will amount to Cdn $121,149.40 (assuming that top personal marginal rates are applicable).

Table 1 below sets out the tax consequences arising as a result of the death of Mrs. Roberts in relation to the Florida residential property.

Table 1 – Tax Liability to Estate (Cdn $)

U.S. Estate Tax	$73,802.40
Cdn Capital Gain	$461,470.00
Cdn Federal Tax on CG	$66,913.00
Credit for U.S. Estate Tax	($73,802.40)
Net Federal Tax on CG	$0.00
Ontario Tax on CG	$47,347.00
Total Tax	$121,149.40
Effective Tax Rate	26.25%

Once this tax is paid and assuming that the heirs of Mrs. Roberts wish to retain the property then consideration should be given to holding the property in a "residence trust" to reduce future tax exposure. The property would need to be sold to such a trust to avoid U.S. gift tax, but the tax basis in the property increased to fair market value at date of death so the gain may be fairly minimal. The use of a residence trust is discussed further in the third case study, below.

Joint Tenancy - U.S. issues

When the Roberts originally purchased the property, they could have considered buying it as tenants in common. Tenants in common may have equal or unequal shares of a tenancy in common interest in a property. Upon the death of a tenant, the deceased tenant's share passes to the deceased's heirs or whomever is designated under the deceased's Last Will. Thus, in the appropriate situations, the tenancy in common offers more flexibility and potential U.S. estate tax savings, particularly if appropriate testamentary trusts are provided in each tenant's Will.

Another advantage offered by a tenancy in common is that the value of the property at each tenant's death may be reduced by a discount to reflect this form of co-ownership. A tenancy interest is less marketable than a sole interest in property.

If a couple own the U.S. property as joint tenants, severing the joint tenancy into a tenancy in common (based on the contributions of each spouse to the property) to achieve the advantages noted above should be considered. It is important, however, that the interest of each tenant in common reflects the proportionate consideration each supplied for the property. If it does not, then U.S. gift tax may result.

The disadvantage to a tenancy in common is that probate is required at each tenant's death, and a U.S. estate tax filing may also need to be made at each death.

As an aside it is worth noting that NRAs sometimes consider reducing their exposure to U.S. estate tax by having the U.S. real property owned by their children as tenants in common. This poses several pitfalls, however. First, if the property is already owned in a parent's name, U.S. gift tax results if the tenancy in common interests that are gifted are in excess of the annual exclusion for each donee (U.S. $14,000 in 2015). Second, if the children allow the parent continued use of the property after titling it in the children's names, the IRS may argue the parent retained an interest in the property and thus the parent remains exposed to U.S. estate tax. Third, this structure can result in ownership issues if the children do not get along, because co-tenants have the right of partition and can force the sale of the property.

Summary/Conclusions

In this simple example the Roberts family was able to defer the tax liability arising as a result of the ownership of the Florida residential property held initially by Mr. and Mrs. Roberts as joint tenants by right of survivorship until the death of the second spouse to die (in this case Mrs.

Roberts). This result was achieved because at the time of Mr. Roberts' death his pro-rated estate tax exemption available was sufficient to shelter his estate from actual payment of U.S. estate tax and because of the rollover provided under the Canadian Act. Ultimately, a U.S. estate tax liability arose at the time of Mrs. Roberts' death as well as a capital gain for Canadian purposes. As a result of the Treaty the U.S. estate tax liability was credited against the Canadian tax liability in respect of the Federal portion of the taxes (although not for the Ontario provincial tax). Depending on the facts of the case such an "optimal" result may or may not be achievable and for this reason ownership of U.S. vacation properties by spouses as joint tenants by right of survivorship, although attractively simple, may not be the best planning technique in all circumstances.

Case Study Two

Introduction

As was seen in our first case study, ownership of U.S. vacation properties by spouses as joint tenants by right of survivorship is only (somewhat) tax effective if U.S. estate tax can be credited against the Canadian capital gains regime. In our second case study we address the post-mortem consequences of a type of planning that was undertaken before this crediting mechanism under the Treaty was put into place. This second case study is also one many practitioners are likely to see in the next few years as vacation properties acquired during the 1990s pass to the next generation.

The Facts

Mr. Smith and his wife, Mrs. Smith (both residents of Toronto and exclusively Canadian citizens) purchased a residential home in Florida in 1999 through a corporation incorporated pursuant to the *Business Corporations Act* (Ontario) (the "SPC"). At the time of incorporation Mr. Smith loaned funds in the amount of Cdn $585,917.00 to the SPC to finance the purchase of the U.S. residential property. In addition, Mr. Smith subscribed for 100 common shares of the SPC for Cdn $100.00. The SPC acquired the Florida residential property for Cdn $585,917.00 which sum was equal to U.S. $400,000.00 (reflecting the exchange rates at the time). Mr. Smith died in 2008 and pursuant to Mr. Smith's last Will and Testament the indebtedness owing by the SPC and the 100 common shares of the SPC were left to Mrs. Smith who inherited both the debt and the shares at cost pursuant to subsection 70(6) of the Canadian Act. Mrs. Smith died in 2015. At the time of her death the residential property owned by the SPC was worth Cdn $841,097.00 and U.S. $650,000.00. Mrs. Smith's last Will and Testament provided that Mr. and Mrs. Smith's sons, Joe and Bob Smith, share equally in the residue of her estate. Joe and Bob are exclusively Canadian citizens and are both resident in Canada. The shares and indebtedness of the SPC are now held by Joe and Bob Smith in their capacities as the executors of the estate of Mrs. Smith.

Joe and Bob are not interested in retaining the property for personal use and will have the SPC sell the residential property in Florida. However, Joe and Bob wish that any planning undertaken will be done in a manner which will minimize taxes on both sides of the border.

U.S. Tax Law Issues

The sale by the SPC of the Florida residential property will have U.S. tax implications to the SPC. Unfortunately for Joe and Bob, ownership of U.S. real property by a corporation results in a higher tax rate than if the property were owned outside a corporate structure. This is because the U.S. does not have a preferential capital gains rate for corporations. Therefore if Joe and Bob decide to have the SPC sell the Florida residential property, the U.S. federal tax rate will apply at a rate of approximately 34% to the gain realized as a result of such a sale, whereas had the real property been owned individually, the top U.S. federal tax rate would have been 20%. Also, Florida has a corporate state tax of 5.5% (although it does not have a state tax for individuals). Therefore, a combined rate of 38% U.S. federal and state tax would be applicable to the sale by the SPC of the Florida residential property. (The state tax is deductible for purposes of arriving at the federal tax.) This would result in an aggregate U.S. federal and state tax liability to the SPC of approximately U.S. $90,000 on the sale of the property. If an individual or trust had owned the Florida residential property and sold it, the U.S. tax would have been only U.S. $50,000.

Joe and Bob in their capacity as executors may have also considered distributing the Florida residential property from the SPC to them in their capacity as shareholders of the SPC rather than selling it. From a U.S. perspective this would still have triggered the relevant gain. The U.S. income tax would be triggered either upon a distribution of the property from the SPC to the estate (being the shareholder), a sale of the property by the SPC, or a transfer of the property in repayment of the loan previously made to the SPC. Any transfer by the corporation is subject to the "FIRPTA" U.S. withholding tax rule. FIRPTA operates by requiring a withholding of the U.S. tax by the transferee of the property with payment of such tax directly to the IRS. This mechanism is designed to assure the U.S. government that the tax will be paid.

The rate of withholding tax does vary if there is a distribution from a corporation to a shareholder, as opposed to a sale by a corporation. Upon a distribution from a corporation to a shareholder the U.S. tax rate of withholding federally is 35% of the gain. On the other hand, a sale of the property by a corporation is subject to a withholding tax of 10% of the gross proceeds of the property. In either case, the rate of withholding tax can be reduced if the actual tax on the transaction would be less than the withholding tax and an application for a reduced rate of withholding certificate is filed with the IRS. Regardless of the amount of withholding tax, the amount of the actual tax that will be payable by the SPC will be the same whether the SPC sells the Florida residential property or distributes it to its shareholders. The SPC would also be responsible for filing IRS Form 1120-F and the Florida corporate tax return (Florida Form F-1120) to report the relevant transaction(s) and pay any tax that was not withheld at the time of the transfer.

It should also be noted that Florida stamp tax, at the rate of U.S. $7.00 per U.S. $1,000, applies to a transfer of property where consideration is involved, such as a sale of the property or when there is an encumbrance on the property.

Finally, the IRS has indicated that it may assert U.S. that estate tax should apply on the death of a NRA shareholder of a foreign corporation that owns personal use real property, on the basis that the corporation is a sham or should be disregarded as lacking economic substance. Therefore, if the corporate formalities were not followed for the SPC (such as appropriate tax filings in Canada, minutes of meetings, etc.) there is more risk that the IRS could argue that the real property was owned by Mr. or Mrs. Smith at either death, and therefore exposed to U.S. estate tax.

Canadian Tax Law Issues

In addition to the U.S. tax implications Joe and Bob will also need to consider the Canadian tax implications of their particular scenario. From a Canadian perspective, pursuant to subsection 70(5) of the Act, Mrs. Smith was deemed to have disposed of each of her capital properties immediately before her death for proceeds equal to their fair market value. Consequently, Mrs. Smith was deemed to have disposed of her shares of the SPC at fair market value immediately before her death. The tax cost to the estate of Mrs. Smith of its common shares in the SPC is now the fair market value at that time.

For the purposes of valuing the common shares of the SPC immediately before Mrs. Smith's death, it is arguable that the fair market value of such shares should be adjusted to reflect the latent U.S. taxes owing in respect of the underlying U.S. real property held by the SPC. A discount in respect of such tax between 50% and 100% of such taxes should arguably be applied to the valuation of the common shares of the SPC.[66] In this case study a 100% discount is used because the property is being sold immediately. Furthermore, because the Estate of Mrs. Smith is owed Cdn $585,917.00, the capital gain arising on the death of Mrs. Smith in relation to her shares of the SPC (assuming that the fair market value attributable to the shares of the SPC is reduced by "trapped-in" U.S. corporate taxes of Cdn $115,344) is Cdn $139,836.

Table 2 below sets out this computation.

TABLE 2 – Capital Gain on the Shares of the SPC on Death in $ Cdn

FMV of Shares	$139,836.00
Less ACB	$100.00
Capital Gain	$139,736.00
Tax Payable @ 24.76%	$34,598.63

Joe and Bob also need to be aware that as a result of changes in the administrative practices of the CRA made due to changes to the Treaty, holding personal use U.S. real property through a

corporation is no longer an acceptable planning technique for Canadians.[67] Specifically, as a result of the aforementioned changes the administrative concessions formerly applicable to so called "single purpose corporations" (being Canadian corporations incorporated for the sole purposes of owning U.S. residential real property) which formerly precluded the assessment of shareholder benefits in certain scenarios no longer apply to Joe and Bob's interests in the SPC. The CRA has specifically stated the administrative concessions that were formerly granted to shareholders of single purpose corporations will not apply in respect of any new property acquired by a Canadian single purpose corporation or in respect of a person who acquires shares of a single purpose corporation unless such share acquisition is as a consequence of the death of the acquiree's spouse or common-law partner.

In this case, Mrs. Smith's estate was able to have the SPC sell the property very quickly avoiding the issue of shareholder benefits altogether.

Returning to the tax implications to the SPC of the sale of the Florida residential property, Table 3 below (which was prepared on the basis of a simulated T2 corporate income tax return)[68] sets out the corporate taxes resulting from the sale of the property by the SPC:

TABLE 3 – Corporate Tax Consequences of Sale

		U.S. $	Cdn $
	Sale Proceeds	$650,000.00	$841,097.00
	Cost / ACB	$400,000.00	$585,917.00
U.S.	Gain	$250,000.00	$255,180.00
	TCG		$127,590.00
	U.S. Federal Tax	$75,387.50	$97,551.13
	Florida Tax	$13,750.00	$17,792.44
	Total U.S. Tax	$89,137.50	$115,343.57
Canada			
	Federal Tax		$0.00
	Ontario Tax		$0.00
	Refundable Portion of Part I Tax		$0.00
	RDTOH End of Year		$0.00
	CDA Credit		$127,590.00

As illustrated by Table 3 above, the sale by the SPC of the Florida residential property will result in a capital gain to the SPC for Canadian tax purposes to the extent that the proceeds of disposition exceed the adjusted cost base to it of the Florida residential property. However, because the income arising on the aforementioned capital gain is foreign investment income

which produces foreign non-business income tax credits, there is no corporate income tax, no refundable portion of Part I tax and therefore no RDTOH at the end of the year in this case.

After the sale of the Florida vacation property by the SPC there are two possible options from a Canadian perspective to extract the proceeds from the SPC in a tax efficient manner. However, this paper is not intended to provide a detailed analysis of post-mortem strategies to extract funds from private corporations.[69]

The first possibility for extracting the proceeds from the SPC would be to conduct a so called "redemption strategy" whereby the SPC would redeem the shares of the SPC triggering a deemed dividend to the Estate of Mrs. Smith pursuant to subsection 84(3) in the amount by which the amount paid by the SPC on the redemption of those shares exceeds the paid-up capital in respect of those shares immediately before that time. Pursuant to paragraph (j) the definition of "proceeds of disposition" in section 54 of the Canadian Act, the dividend deemed by subsection 84(3) to be a dividend received is not included in the proceeds of disposition in respect of the shares so redeemed. Consequently, a capital loss will arise on such a redemption. Pursuant to subsection 164(6) if the Estate of Mrs. Smith elects within the first taxation year of her estate, the capital loss arising on the foregoing redemption can be applied in respect of Mrs. Smith's last taxation year.[70]

The Estate of Mrs. Smith may wish to treat some or all of the aforementioned deemed dividend as a capital dividend (to the extent to of the credit to the SPC's capital dividend account).However, subsection 112(3.2) (which will be implicated when capital dividend account is utilized) will limit the loss arising on such a redemption pursuant to certain rules therein. Therefore in order to achieve an optimal result it may be necessary to conduct certain planning so that in effect only a portion of the aforementioned deemed dividend is comprised of a capital dividend.

Unfortunately, there are certain complexities involved in achieving this result because subsection 83(2) requires that a capital dividend election apply to the full amount of a dividend. Mechanically this can be accomplished by first increasing the legal stated capital on the shares of the SPC held by the Estate of Mrs. Smith triggering a deemed dividend to the Estate and then treating the full amount of this deemed dividend as a capital dividend. This deemed dividend will also increase the cost base of the shares of the SPC held by the Estate in the amount of the deemed dividend.

The redemption can then be undertaken with the effect that the deemed dividend arising will be the difference between the redemption amount and the new (higher) paid up capital to the Estate in respect of the shares of the SPC. This second dividend can be treated as an ordinary taxable dividend. This planning will have the effect of treating the desired portion of the redemption proceeds as a capital dividend and the desired portion of the redemption proceeds as a taxable dividend.

Table 4 below sets out the tax consequences of the redemption strategy but breaks out this strategy into two scenarios one where in effect half of the deemed dividend is treated as a capital

dividend and on one where in effect the deemed dividend to the extent of the credit to the capital dividend account of the SPC is treated as a capital dividend.

TABLE 4 – Redemption Strategies (in Cdn $)

	50% Solution	100% Solution
Deceased		
FMV of Shares	$139,836.00	$139,836.00
Less ACB	$100.00	$100.00
Gain Before Loss	$139,736.00	$139,736.00
Loss Carryback	$139,736.00	$82,014.00
Net Gain (Loss)	$0.00	$57,722.00
Tax on Gain @ 24.76%	$0.00	$14,291.97
Estate		
Proceeds / ACB	$139,836.00	$139,836.00
Capital Dividend	$69,868.00	$127,590.00
Taxable Dividend	$69.868.00	$12,146.00
Tax on Taxable Dividend @ 40.13% (non-eligible)	$28,038.03	$4,874.19
Loss Carryback		
Loss on Redemption	$139,736.00	$139,736.00
Stop Loss Limitation	$0.00	$57,722.00
Available Loss	$139,736.00	$82,014.00

The second possibility for extracting the proceeds from the SPC would be to undertake so-called "pipeline" planning in respect of the shares of the SPC. Such a strategy would involve the sale of the shares of the SPC to a newly incorporated holding corporation in exchange for shares. Section 84.1 should not preclude the addition to the legal stated capital in respect of the shares of the new holding company an amount equal to the Estate's adjusted cost base in the shares of the SPC.[71]

The two corporations can then be amalgamated or an intercorporate dividend paid either directly (or through a redemption if there are subsection 55(2) concerns, (which are beyond the scope of this paper)) so that the funds are at the holding company or amalgamated company level. The

funds can then be removed tax free as reduction of paid-up capital on the shares of the amalgamated company or the newly incorporated holding company as the case may be.

Table 5 below sets out the tax consequences of the pipeline strategy.

TABLE 5 – Pipeline Strategy (in Cdn $)

Deceased	
Deemed Proceeds	$139,836.00
ACB	$100.00
Capital Gain	$139,736.00
Tax on Gain @ 24.76%	$34,598.63
Estate & Corporate Tax	
Tax to Newco on Redemption of SPC Shares	$0.00
Tax to Estate on PUC Return	$0.00

Table 6 illustrates the so-called "pipeline" strategy in comparison to the two redemption strategies.

TABLE 6 – Redemption and Pipeline Strategies Compared (in Cdn $)

	50% Solution	**100% Solution**	**Pipeline**
Sale Proceeds	$841,097.00	$841,097.00	$841,097.00
Total US Corp Tax	$115,343.57	$115,343.57	$115,343.57
Total CDN Corp Tax	$0.00	$0.00	$0.00
Tax - CG at Death	$0.00	$14,291.97	$34,598.63
Tax - Taxable Dividends to Estate	$28,038.03	$4,874.19	$0.00
Net Cash	$697,715.40	$706,587.27	$691,154.86

The foregoing tables indicate that in this case the most advantageous planning is the redemption strategy employing the so-called "100% solution" which results in net cash available for distribution of Cdn $706,587.27 of which Cdn $585,917.00 would be distributed in repayment of the amount owing by the SPC to the Estate of Mrs. Smith.[72]

It should be noted that "pipeline" strategies have attracted increased attention from the CRA and in light of the Federal Court of Appeal's decision in *MacDonald v. R.*[73], special care must be taken to ensure that subsection 84(2) will not apply to the extraction of funds. One possibility to reduce risk on this front would be to comply with the CRA guidelines as laid out in a number of advance income tax rulings which set out the circumstances in which in the opinion of the CRA subsection 84(2) will not apply. These conditions are as follows:

1. The original corporation's business will continue for at least one year following the implementation of the pipeline structure.
2. The original corporation will not be amalgamated or wound-up into the pipeline corporation for at least one year.
3. The original corporation's assets will not be distributed to the shareholders for at least one year, followed by a progressive distribution of the corporation's assets over an additional period of time.[74]

However, arguably in the case of the SPC subsection 84(2) will not be applicable in any event as in order for subsection 84(2) to apply there must be, among other things, a "winding-up, discontinuance or reorganization of its business". Therefore the SPC must have a business in order for subsection 84(2) to be applicable.

The question of whether a corporation is carrying on a business has been examined by the courts in a number of different scenarios. The leading cases on the question of whether a business is present are *Ensite v. The Queen*, 86 DTC 6521 and *Canadian Marconi Company v. The Queen*, 86 DTC 6526. In *Marconi*, the Supreme Court held that income of a corporation is prima facie income from a "business"; however, this presumption is rebuttable. Whether this presumption can be rebutted depends on a number of factors including the number of transactions, the volume of transactions, the frequency of transactions, the turnover of investments and the nature of investments.[75] In *Ensite*, the Supreme Court expounded the "employed and at risk" test with respect to financial instruments ostensibly earning property income. The "employed and at risk test" was described by the Supreme Court in Ensite as follows,

> The test is not whether the taxpayer was forced to use a particular property to do business; the test is whether the property was used to fulfil a requirement which had to be met in order to do business. Such property is then truly used employed and risked in the business.

Thus income from "property" can nevertheless constitute income from business provided that such property was required to be employed and risked in order to do business. In the case at hand the SPC is simply using a corporation to hold essentially a property used primarily for

recreational enjoyment. It is doubtful that property held for such a purpose could constitute a "business" of the SPC. However, the CRA has stated that:

> in the context of applying subsection 84(2), the CRA would generally not differentiate between a corporation carrying on an active business and a corporation carrying on a business of earning income from property when considering whether funds or property of a corporation resident in Canada have been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders, on the winding-up, discontinuance or reorganization of the corporation's business.[76]

The CRA's position on this seems somewhat of a stretch given the jurisprudence on this matter but caution is in order notwithstanding. It is beyond the scope of this paper to delve further into subsection 84(2). Any pipeline planning will necessarily have to take account of the contentious issues surrounding this planning.

Planning Options/Comments

For illustrative purposes suppose that Bob and Joe had wished to retain the Florida residential property. However also suppose that given the adverse tax implications of distributing the property from the SPC, Bob and Joe decided to keep the property in the SPC, use it for themselves personally and rent it out when not using it. In that event Bob and Joe would need to be concerned about taxable benefits arising as a result of subsection 15(1) of the Canadian Act.

The CRA has indicated that the taxable shareholder benefit would generally be determined as follows:

> fair market value rent for the property – Consideration paid to the corporation by shareholder for use of property = Shareholder benefit.[77]

If the fair market value rent is not an accurate measure or cannot be determined, the benefit will be based on imputed rent, calculated as follows[78]:

> Greater of the property's cost and fair market value – Interest-free loans or advances to the corporation for the acquisition of the property = Net amount
> × Normal rate of return
> = Subtotal
> + Operating costs related to the property
> = Imputed rent
> – Consideration paid to the corporation by the shareholder for use of property
> = Shareholder benefit.

The CRA has also indicated that the imputed rent calculation may be appropriate for a luxury residence.[79]

As noted in the section above, continued ownership of the property by the SPC has its downsides from a U.S. perspective.
Summary/Conclusions

Our second case study appears to have amply demonstrated that there are a good number of complexities surrounding the winding-up of a single purpose corporation structure used to hold U.S. real property on the death of the second spouse. However, our second case study has hopefully also demonstrated that with appropriate planning the adverse tax consequences can be mitigated to some degree (although not entirely).

Case Study Three

Introduction

In our first and second case studies we addressed the tax implications of two common forms of ownership used to hold U.S. vacation properties; joint tenancy by right of survivorship and the use of a "single purpose corporation". Our third case study deals with another common method of ownership; ownership of a US vacation property held through a trust. Hopefully this case study will be of use to practitioners in identifying cross-border pitfalls associated with this form of ownership.

The Facts

Mr. Rothbee (a resident of Ontario, Canada at the time and exclusively a Canadian citizen) wishes to purchase a residential property in Florida. On the advice of his accountant the Florida property will be acquired for Cdn $400,000 through a resident Canadian discretionary *inter vivos* trust (the "Trust") for the benefit of his spouse Mrs. Rothbee and his issue who are all resident in Ontario and are not U.S. persons. Advice needs to be given regarding the ongoing maintenance of the trust and planning regarding the consequences of the 21 year deemed disposition year rule.

In the alternative, suppose that Mr. Rothbee had purchased the property personally and has now sought advice as to whether alternative planning would be advisable.

U.S. Tax Law Issues

In this scenario, planning <u>before</u> the purchase of the U.S. real property provides the optimal result. Once the property is purchased, transferring it could result in U.S. tax. A transfer without consideration results in U.S. gift tax which applies at a 40% rate (at the top margin) on the value transferred that is not covered by applicable exemptions or exclusions (which are quite limited, as noted in the introductory section of this paper). If there is a transfer for consideration, U.S. and Canadian income tax may arise as well as Florida stamp tax.

Assuming that the planning is done before the property is purchased, the typical recommendation in a situation like this would be to consider the use of an Ontario trust resident in Canada to purchase the U.S. real property. Ideally, the trust itself will be formed before a purchase offer is signed or a deposit is made; if that is not done, the trust approach can be used but any deposit should be refunded by the trust to the original depositor and a new purchase offer should be made in the name of the trust.

The trust typically would have one spouse as the "grantor/settlor" and the other spouse as the trustee and a beneficiary. Issue of the settlor may also be beneficiaries. The grantor/settlor spouse cannot be a trustee or a beneficiary (or have any power or interest in the property, including a reversionary interest). Anyone who is a beneficiary and also a trustee cannot have full discretion to make distributions from the trust to himself or herself, but rather would be limited to making distributions for "health, education, maintenance (accustomed in the standard of living of the beneficiary) and support", an acronym known as "HEMS". If there were an "independent trustee" (generally meaning someone not related to the settlor or the beneficiaries) then the independent trustee could have full discretion over distributions, and also full discretion concerning the time at which the trust should be terminated. This can be particularly useful in light of the Canadian "21 year" rule.

The structure works to avoid U.S. estate tax at the death of the grantor/settlor or any beneficiary, as long as the property remains owned by the trust. The grantor/settlor spouse can use the property only at the "sufferance" of the beneficiary spouse, thus protecting both spouses from U.S. estate tax exposure. If the beneficiary spouse should be divorced from the settlor, or the beneficiary spouse should die, then the settlor would need to rent the property at fair market value (based on days of use) in order to maintain the integrity of the structure.

In addition to the U.S. estate tax protection while the property remains in the trust, a further benefit to the structure is that upon a sale of the property, the preferential U.S. capital gains rate is available (presently with a top rate federally of 20%). Moreover, real property owned in Florida by a trust would not be subject to a Florida state tax (unlike with a corporation, as illustrated in our second case study).

Use of a trust structure generally results in little ongoing administrative maintenance, as long as the property is not rented or sold. It is important that capital expenditures are made only by the settlor (directly or via a contribution to the trust). The maintenance expenses can be paid by either the settlor, one or more beneficiaries, or the trust itself. As it becomes increasingly complex for a trust to open a U.S. bank account, maintaining a U.S. dollar account for the trust at a Canadian bank may be preferable.

Of course, an important consideration in the structure is that, as noted below, the Trust must recognize the accrued gain in the property every 21 years, unless the property is distributed from the Trust prior to the expiry of the initial 21-year period. If the property is to be distributed, thought should be given to the best potential beneficiary to receive the property, since that puts the property in someone's estate again and thus U.S. estate tax exposure. Often times the optimal distributee will be a member of the younger generation, although if that is done and a

parent wishes to use the property thereafter, the parent should pay fair market value rent as there are a number of cases where the IRS has treated real property owned by children but used primarily by a parent as actually still being the parent's property for U.S. estate tax purposes. A distribution of the property from the Trust to a beneficiary generally would not be subject to U.S. income tax, unless the Trust made an election to subject the gain to U.S. income tax at the time of the distribution.

Canadian Tax Law Issues

On an ongoing basis, the Trust will need to address payment of the cost of operating and maintaining the Florida property. Typically, the family member using the property would pay for those expenses. Some consideration could be given to having rules in the Trust deed governing the use of the Florida property.

In addition, another issue with respect to holding a residential property in a trust is the potential applicability of subsection 105(1) of the Canadian Act which could result in a taxable benefit to the user.[80] The administrative position of the CRA is that the use by a beneficiary (or a person related thereto) of personal-use property (including real property) owned a trust will not constitute a benefit within the meaning of that subsection.[81]

For Canadian purposes the Trust raises the potential application of certain Canadian attribution rules. Subsection 75(2) should not be applicable in this case because the settlor is neither a beneficiary nor a trustee. However, the ordinary attribution rules in sections 74.1, 74.2 and 74.3 could be relevant with respect to income or capital gains distributed or made payable to the settlor's spouse or income distributed or made payable to the settlor's minor children or other issue. If income and capital gains are retained in the Trust no attribution should arise.

Pursuant to subsection 104(4) (on the basis that the Trust is not a spouse trust), the Trust will be deemed to have disposed of its capital assets at proceeds equal to their fair market value on the day that is 21 years after the day on which the Trust was created. Therefore at some point prior to the deemed disposition it may be desirable to transfer the residence owned by the Trust to the beneficiaries. As noted in the previous section, the optimal distributee would be a member of the younger generation. In order to protect the settlor spouse it may be advisable for that spouse to have a long term lease with respect to the Florida residential property.

By virtue of subsection 107(2) the residence can be distributed to beneficiaries of the Trust on a tax-deferred basis (assuming the trust was not one to which subsection 75(2) was applicable)[82]. It bears mentioning that pursuant to subsection 107(2.001) or subsection 107(2.01) (if the property is a principal residence) an election can be made when the Trust makes a distribution of capital property to a beneficiary in satisfaction of that beneficiary's capital interest in the trust. If either of these elections is made then the distribution will occur on a taxable basis. These elections would only be made if the Trust made an election to subject the gain to U.S. income tax at the time of the distribution

If Mr. Rothbee had purchased the property himself and now wished to transfer the Florida residential property to an ordinary *inter vivos* trust, this transfer would be a disposition for Canadian tax purposes resulting in the triggering of any accrued capital gains.[83] From a U.S. tax perspective, fair market consideration should be paid by the trust for the property, and thus there will be U.S. income tax on any gain as well. If consideration is not paid, U.S. gift tax would arise on the full value (and not just on the accrued gain) as a result of the transfer by Mr. Rothbee to the trust.

There are certain circumstances in which property can be transferred to a trust on a tax deferred basis from a Canadian (but not a U.S.) perspective. Pursuant to subsection 73(1) property may transferred by a Canadian resident individual (other than a trust) on a tax deferred basis to a trust that is resident in Canada if the circumstances to which the rules in subsection 73(1.01) apply. However, such rollover trusts are beyond the scope of this paper. It suffices to say that the most likely scenario will be that the transfer of the Florida residential property to a trust will likely be taxable from both a Canadian and U.S. perspective.

Planning Options/Comments

Consequently, from a Canadian perspective, Mr. Rothbee's options with respect to the Florida residential property as the trust approaches the 21 year rule would be to distribute the property to the capital beneficiaries of the trust on a rollover basis to the beneficiaries of the trust or to elect to treat the transfer to occur on a taxable basis pursuant to subsection 107(2.01). In addition, in order to avoid any issues of triggering accrued gains (including as a result of currency fluctuations) purchasing the Florida residential property initially through a trust would be preferable than purchasing it individually and subsequently selling the property to a trust.

The "ideal" situation for using a Canadian trust to own the property is when there is a long term, stable marriage and the spouses are at an age where either they are unlikely to live out a 21 year term or would be sufficiently elderly and unlikely to be spending significant time in Florida at the 21st anniversary. On the other hand, for younger purchasers, or for unmarried purchasers with children, the trust is often still very helpful. An unmarried purchaser could not be a beneficiary or trustee, but he could rent the property from the trust for the days he wishes to use it. Such rents can be used towards maintenance costs. The trust is an "insurance policy" in case there is a death during the term of the trust. Moreover, the advantages of avoiding probate and U.S. estate tax filings are further benefits to use of the trust structure.

In order to protect the settlor/spouse in the case of the death of the other spouse or a divorce, or to protect both spouses in the case of a distribution of the property to the younger generation, and to avoid U.S. estate tax exposure, consideration should be given to a lease for settlor/spouse to be able to use the property by paying fair market value rent.

Possible Sole Ownership

Suppose Mr. Rothbee decides to be the sole owner of the property. In such case, on his death, his estate may be liable for U.S. estate tax. If Mr. Rothbee decides to proceed in this manner, he should consider having a Last Will creating an appropriate testamentary trust for his surviving spouse and/or children in order to keep the Florida property from being subject to estate tax in the survivor's estate, to the greatest extent possible in light of exemptions that may be available to his estate.

A few requirements must be met for the creation of this testamentary trust. First, the surviving spouse (or other beneficiary) cannot participate in decisions for distributions other than for health, education, maintenance, and support.[84] An "independent trustee", however, could have the ability to encroach capital for the beneficiaries for any reason. Furthermore, a beneficiary cannot appoint the trust to himself or herself, the beneficiary's creditors, the beneficiary's estate or creditors of the beneficiary's estate. Finally, a beneficiary must have limitations on his or her ability to remove trustees.

This type of testamentary trust should also be able to be severed so that the portion of the U.S. property that is exempt from U.S. estate tax due to the pro-rated unified credit is held in one trust that is out of the estates of the heirs (because this trust has the appropriate terms), and the portion for which estate tax would arise is held in the other severed trust for which a QDOT election can be made, if there is a surviving spouse.

Summary/Conclusions

This case study has again demonstrated that the "decision tree" facing prospective Canadian purchasers of U.S. vacation properties are quite complex. However, hopefully this case study has also demonstrated that appropriate planning can make the use of a trust a helpful tool in managing tax exposure associated with Canadians holding U.S. vacation properties.

Conclusion

As our case studies have hopefully amply demonstrated, the holding of US vacation properties by Canadians raises a surprisingly large number of technical issues. As the applicable rules and administrative concessions over the years have changed so have the planning options. In some cases planning that was thought to be effective in the past has created planning problems today especially as clients aim to migrate from formerly effective planning to currently effective planning. Tax advisors need to keep in mind that although the relevant client goals may be simple, the methods and means are often not. Therefore, caution is in order before purchasing, disposing of, or otherwise dealing with US vacation properties and adequate consideration of the relevant tax and legal issues should be undertaken.

Endnotes

[1] R.S.C. 1985 (5th Supplement) c.1, as amended (referred to herein as the "Canadian Act")

[2] Internal Revenue Code of 1986, as amended (referred to herein as "I.R.C." or the "Code")

[3] Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983; March 28, 1984; March 17, 1995, July 29, 1997 and September 21, 2007 (referred to herein as the "Treaty").

[4] State and local taxes may also apply. Such taxes are beyond the scope of this paper.

[5] Section 7701(a)(30) of the Code defines "U.S. Person."

[6] I.R.C. § 897(a)(1).

[7] I.R.C. § 1(h).

[8] Foreign Investment in Real Property Tax Act, Pub. L. No. 96-499, 94 Stat. 2682 (1980).

[9] I.R.C. § 1445.

[10] I.R.C. § 871(a)(1).

[11] I.R.C. § 871(d).

[12] The U.S. generation-skipping transfer tax is not further discussed herein, as it has limited applicability to NRAs.

[13] As noted, a U.S. citizen is a U.S. Person. A U.S. tax resident for income tax purposes is defined under the rules set forth in Section 7701(b) of the Code, generally as someone meeting the "substantial presence" test or holding a green card as a lawful permanent resident. For transfer tax purposes, however, the test for U.S. residency is based on domicile: a U.S. resident is defined as a person who is not a U.S. citizen, and who is physically present in the U.S. with the intent to remain there permanently. *See* I.R.C. § 2001(a); Reg. § 20.0-1(b). In this paper, "U.S. Person" means a U.S. citizen or an individual domiciled in the U.S., in the context of discussions of the transfer tax system.

[14] I.R.C. § 2511(a).

[15] I.R.C. § 2501(a)(2).

[16] I.R.C. § 1015.

[17] I.R.C. § 2503(b)(1). This amount is indexed for inflation.

[18] I.R.C. § 2522.

[19] I.R.C. § 2522(b).

[20] I.R.C. § 2523(a).

[21] I.R.C. § 2523(i).

[22] I.R.C. § 2523(i)(2). This amount is indexed for inflation.

[23] Treas. Reg. § 25.2523(i)-1(c)(1).

[24] I.R.C. § 2505(a).

[25] *Id.*

[26] I.R.C. § 2001(a).; 2031.

[27] I.R.C. §§ 2101(a); 2103.

[28] *See* I.R.C. § 2104.

[29] I.R.C. § 2105(b).

[30] I.R.C. § 2105(a).

[31] I.R.C. § 2104(b).

[32] Treas. Reg. § 20.0-2(b)(2).

[33] *Id.*

[34] *See* I.R.C. §§ 2035-2036.

[35] For U.S. citizens and residents, only one-half of property that is jointly held with a right of survivorship is included in the estate of the first tenant to die. I.R.C. § 2040. If U.S. situs property is owned jointly with a NRA spouse, the value that is included in the gross estate depends on the proportionate consideration the spouses provided towards the purchase of such property. The presumption for NRAs, on the first joint tenant's death, is that the full value of the property is included in the decedent's estate, unless the estate can demonstrate the extent of the surviving spouse's contributions. *See* Treas. Reg. § 25.2523(i)-(2).

[36] I.R.C. § 2041(a).

[37] I.R.C. § 2042(1).

[38] I.R.C. § 2039.

[39] I.R.C. § 2051.

[40] I.R.C. §§ 2053; 2054; 2055; 2056.

[41] I.R.C. § 2106. This same proportion is used to determine the amounts of pro-rated unified and marital credits available to the estate of a Canadian decedent owning U.S. situs property allowed under the Treaty, as will be discussed later in this paper.

[42] Treas. Reg. § 20.2106-2(a)(2).

[43] I.R.C. § 2106(b).

[44] The Treaty, Article XXIXB, Paragraph 1.

[45] I.R.C. § 2056.

[46] I.R.C. § 2056(a)(7).

[47] I.R.C. §§ 2056(d)(1)(A); 2056A.

[48] Treas. Reg. § 20.2056A-4(b)(1).

[49] I.R.C. § 2051; Treas. Reg. § 20.0-2(b)(3).

[50] *See* I.R.C. § 2001(b); I.R.C. § 2502(a).

[51] I.R.C. § 2010(a).

[52] I.R.C. § 2102(b)(1).

[53] The Treaty, Article XXIXB, Paragraph 2.

[54] The Treaty, Article XXIXB, Paragraph 3.

[55] I.R.C. §§ 2013(a); 2102(a), (b)(5).

[56] I.R.C. § 2010(c).

[57] I.R.C. § 2102(b)(1).

[58] The Treaty, Article XXIXB. Paragraph 2.

[59] The Treaty, Article XXIXB, Paragraph 3

[60] The Treaty, Article XXIXB, Paragraph 7.

[61] The Treaty, Article XXIXB, Paragraph 6.

[62] The Treaty, Article XXIXB, Paragraph 5.

[63] I.R.C. § 2522(b).

[64] *See* I.R.C. § 2056(d)(2)(A).

[65] CRA Document No.2010-0379381E5, September 14, 2010. See also Christopher Gandhu, "Gift Tax Planning for US Citizens in 2012" (2012) vol. 2, no. 1 Canadian Tax Focus, 8-9.

[66] See *Zeller Estate v. R.*, 2008 TCC 426, in which the Court allowed the taxpayer's valuation of shares to be adjusted for "trapped-in" capital gains tax liability.

[67] On June 22, 2004, the CRA announced that it was withdrawing its prior administrative policy and that it would be begin assessing a taxable benefit against shareholders who used single purpose corporations to hold real estate for personal use. See Canada Revenue Agency, Income Tax Technical News no. 31, June 22, 2004 (subsequently updated by Income Tax Technical News no. 31R2, May 16, 2006).

[68] The authors wish to thank Ross Cammalleri and Ron Romano both of Collins Barrow Vaughan LLP for preparing the return for the writers.

[69] See for example Armando Minicucci, "Trusts and Post Mortem Tax Planning – A 2014 Update," *2014 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2014), 5B: 1-33. Also see Christopher Falk and Stefanie Morand, "Current Issues Forum: Pipeline Planning; Subsection 164(6) Circularity Issue; Eligible Dividend Designations," *2012 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2012) 1b: 1-26 and Gwen Benjamin and Robert Martini, "Post Mortem Planning: Selected Issues and Planning Tips," *2011 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2011), 5:1-28.

[70] Pursuant to subsection 40(3.61) of the Canadian Act to the extent that the Estate elects in respect of the loss pursuant to subsection 164(6) this loss will not be denied.

[71] Generally speaking section 84.1 of the Canadian Act will preclude the addition to legal stated capital of the shares of the purchaser corporation in excess of the so-called "hard cost" of the shares of the subject corporation (the hard cost very generally speaking being the cost base where a share was acquired from a person with whom the taxpayer was not dealing at arm's length cost base attributable to value other than pre-V-day value or previously claimed capital gains exemption).

[72] It should be noted that under the 50% solution and the pipeline strategy, $57,722.00 and $127,590.00 of CDA credit are respectively not utilized. Our analysis does not consider future possible use of these balances.

[73] MacDonald v. R., 2012 D.T.C. 1145 (T.C.C.) at paras. 67-68, reversed 2013 D.T.C. 5091 (F.C.A.).

[74] CRA Document No. 2011-0403031R3, January 18, 2012(supplemented by CRA Document No. 2011-0417741R3).

[75] See H. Michael Dolson and Jon D. Gilbert, What's Left, "Accessing Surplus: What Works, What Doesn't, What's Left," 2014 Prairie Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2014), 9: 1-57.

[76] Document 2012-0445341C6 dated May 29, 2012.

[77] CRA document no. 2004-0086791C6, October 8, 2004; and Interpretation Bulletin IT-432R2, "Benefits Conferred on Shareholders," February 10, 1995.

[78] Nadja Ibrahim, Abraham D. Piontnica, and Thomas M. Stephens, "Canadians Purchasing US Real Estate," Report of Proceedings of the Sixty-Fourth Tax Conference, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 39:1-33.

[79] *Supra*, note 82. Also see the case on which the CRA's position is based: *Lloyd Youngman v. The Queen*, 90 DTC 6322, (1990) 2 C.T.C. 10.

[80] Subsection 105(1) of the Canadian Act provides that the value of all benefits to a taxpayer during a taxation year from or under a trust be included in computing the taxpayer's income for the year with certain exceptions.

[81] *Income Tax Technical New No. 11*, September 30, 1997 (now cancelled) and CRA document no 2012-0470951E5, December 4, 2012.

[82] See subsection 107(4.1) of the Canadian Act.

[83] Definition of "disposition" in subsection 248(1) of the Canadian Act and also see subsection 69(1) of the Canadian Act.

[84] *See* Treas. Reg. § 20.2041-1(c)(2).

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