US / Canada Cross Border Tax Update

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Issues for US Citizens Resident in Canada

US Citizens Resident in Canada

- Am I a US Taxpayer?
  - Were you born in the United States?
  - Were either of your parents born in the US?
  - Do you maintain a substantial presence in the United States?

US Citizens Resident in Canada

– US citizens are subject to US federal income tax on their worldwide income regardless of where they live

– US Citizens who are Canadian residents are treated as qualifying Canadian residents for purposes of the Canada-US income tax treaty ("Treaty") but the US reserves the right to tax its citizens as if the Treaty were not in effect

– The Treaty does allow Canadian resident US citizens to claim a foreign tax credit for tax paid in Canada

US Citizens Resident in Canada

- As a result of the credit and the fact that Canadian individual income tax rates tend to be higher than US rates, many Canadian resident US citizens do not actually have any US tax liability
- Some important exceptions
  - Income from a controlled foreign corporation
    - A Canadian corporation is "foreign" for this purpose
  - Corporate reorganizations involving Canadian corporations may qualify for deferral only in Canada

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US Citizens Resident in Canada

- Issues involving RRSPs
  - The US generally sees an RRSP as a grantor trust investment income of which is currently taxable to the beneficiary
  - The Treaty permits a Canadian resident to elect deferral treatment
  - The election is not automatic and requires a timely filed IRS Form 8891

US Citizens Resident in Canada

- US Citizens are also subject to US estate and gift tax on their US and foreign situs assets
- Credit is available under the Treaty to avoid double taxation at death
- Canadian resident US citizens who don't pay attention to their US status may overlook planning opportunities to achieve significant US estate tax savings

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US Citizens Resident in Canada

– US Citizens resident in Canada are subject to the same tax and related filing requirements as US residents

– Income tax returns

  - Foreign bank account reports

    – Canadian bank accounts are foreign!

– Reporting interests in foreign corporations, partnerships and trusts

– New Form 8938

US Citizens Resident in Canada

- What if I was unaware or was ignoring my US tax and filing obligations
  - While the penalties for some nonfiling violations are extremely severe, it is often possible to come into voluntary compliance and avoid significant penalties
- What is FATCA and why should US Citizens resident in Canada care?

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Planning for Canadians with US Children

Planning for Canadians with US Children

In a typical Canadian estate freeze transaction whereby the parent owns shares of a Canadian company (“Opco”), the parents’ objectives include the following:

•Minimize capital gains tax payable as a consequence of death;

•Allow for future growth to accrue to the next generation;

•Maintain control of the Opco during his/her lifetime;

•Protect non business assets (Cash) from creditors and potential creditors of Opco.

•Provide for an equal bequest of his/her assets amongst their children.

Planning for Canadians with US Children

A typical estate freeze transaction to accomplish these objectives would involve the following:

Parent would incorporate a new company ("Holdco") presumably under the same jurisdiction as Opco;

•A discretionary family trust ("Trust") is created, with the following attributes:

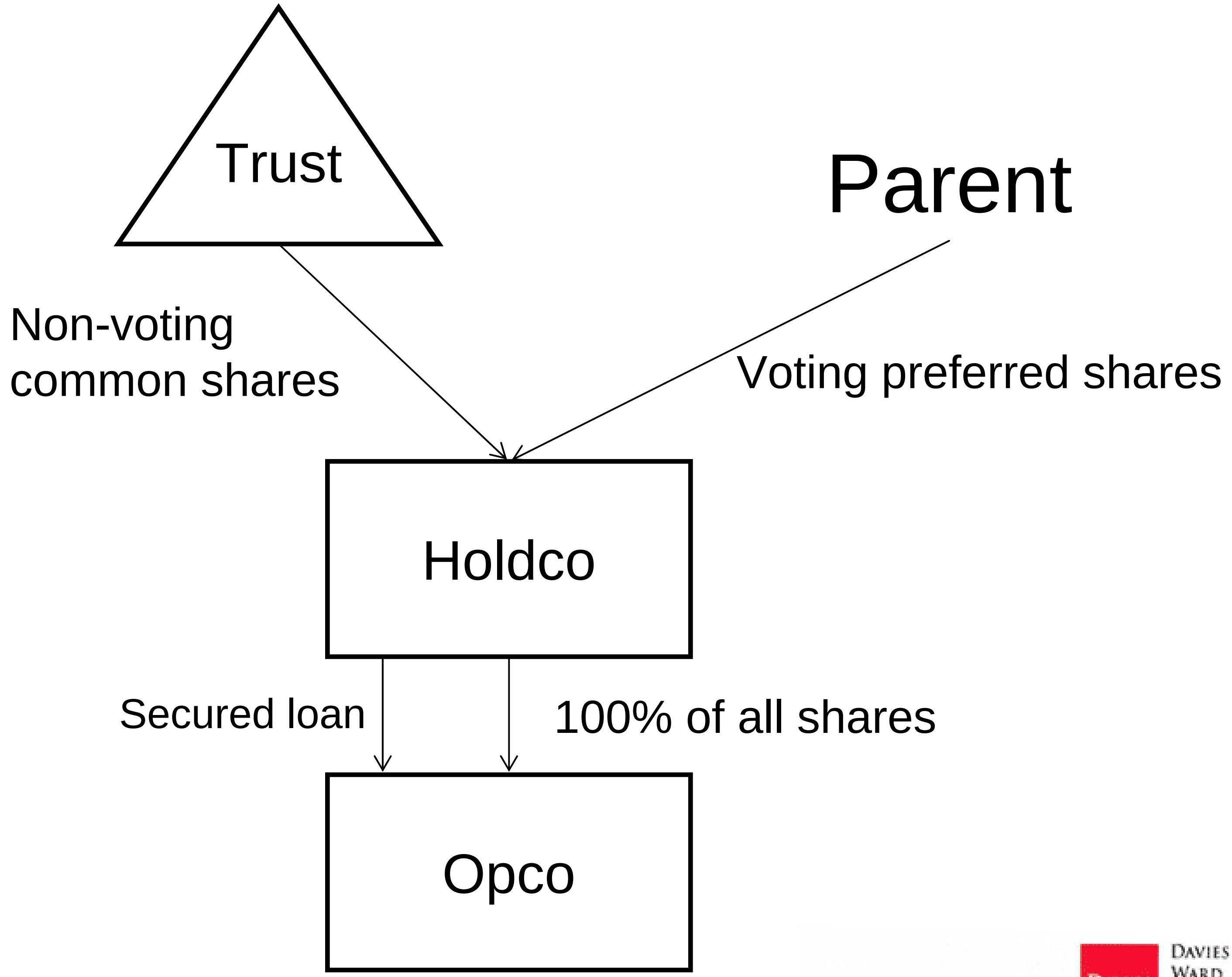
- The Settlor is a family friend or a non beneficiary / Trustee relative;
- The trustees would include Parent and at least one other person who is neither a beneficiary nor a settlor;
- The beneficiaries include, Parent, spouse, children, grandchildren and other corporate beneficiaries;
- The Trust is fully discretionary during the lifetime of Parent.

•Parent transfers his shares of Opco to Holdco on a tax deferred based pursuant to section 85 of the Income Tax Act ("ITA") and the Quebec equivalent. In exchange Parent receives voting preferred shares have a fair market value equal to that of the shares transferred;

•Trust borrows $100 from an arm's length person and subscribes for 100 non-voting common shares of Holdco (this loan must be repaid by the Trust typically from the receipt by the Trust of a dividend from Holdco);

•Opco would then pay a cash dividend to Holdco for an amount equal to its retained earnings;

•To the extent that Opco requires the funds in its operations, it would loan that cash requirement to Opco, registering security on the assets of Opco.



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Planning for Canadians with US Children

The Canadian income tax considerations and consequences of these transactions include the following;

•The fair market value of the preferred shares received by Parent must be equal to fair market value of the common shares transferred.

•The Trust may be validly constituted and appropriately funded to not have the attribution rules (including the reversionary Trust rules).

•Consideration must be given to the corporate attribution rules under subsection subsection74.4(2) of the ITA.

•The possibility of associating Holdco and Opco with a corporation in which a beneficiary is a shareholder as a consequence of the extended definition of control pursuant to subsection 256(1.2)(f)(ii) of the ITA;

•21-year rule (deemed disposition of trust assets at fair market value).

Planning for Canadians with US Children

The US tax implications that need to be considered are dependent upon certain factors and include the following;

- Characterization of companies (Holdco and Opco);
- Characterization of Trust;
- US Reporting requirements
- Estate Tax

Planning for Canadians with US Children

Characterization of Companies

•Foreign companies, the shares of which are held directly or indirectly by US persons, can be classified as either:

-A Controlled Foreign Corporation (“CFC”)

-Passive Foreign Investment Corporation (“PFIC”)

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- A CFC is defined as a foreign corporation of which shares comprising more than 50% of the votes or value are owned collectively by US citizens or residents, but considering only shareholders who own at least 10% of the voting power

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The PFIC rules are much broader in scope that the CFC rules.

A Canadian corporation is a PFIC to a US shareholder if either

i) At least 75% of its gross income for the year is passive income, or

ii) On average for the year, at least 50% of the fair market value of its total assets are passive assets.

- Passive income generally includes dividends (including dividends received from another PFIC), interest, rents, and royalties;

•Passive assets are those that desire passive income. However, the IRS's position is that cash and cash-like assets are passive assets, regardless of a corporation's working capital requirements.

•In establishing the fair market value of any company's assets, goodwill and other intangibles could also be considered in applying this threshold.

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The negative US income tax consequences of CFC status include the following:

•Passive income (known as subpart F income) of a CFC must be included in the income of a US shareholder. Subpart F income generally includes passive income such as dividends, interest, rents, and royalties, and certain related-party sales and services income;

•Earnings of a CFC that are invested in US property must be included in the income of a US shareholder. US property includes stock and debt of US persons, such as loans to a US shareholder;

•In general there are no credits available to a US individual shareholder for Canadian corporate taxes paid by the Canadian corporation (unless the Corporation is a look through entity).

• Any gain on the sale of the shares of a CFC is re-characterized as a dividend to the extent of the CFC's accumulated earnings and profits.

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The negative US income tax consequences of PFIC status include the following:

•"Excess distributions" (a distribution in excess of 125% of the distributions over the last three years) are subject to tax at the highest marginal rate plus an interest charge;

•Any gain on the sale of the shares is treated entirely as an excess distribution (therefore no capital gains tax rate);

•Tax-free reorganizations of the shareholdings are generally not available;

•Shares of a PFIC acquired by inheritance from a US decedent do not generally receive a step-up in US tax basis.

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Fair Market Value of Opco's assets are as follows:

	Example #1	Example #2	Example #3
Cash	$20,000	$40,000	$40,000
A/R	$50,000	$10,000	$10,000
Inventory	$40,000	$20,000	$20,000
Equipment	$55,000	$10,000	$10,000
Goodwill	-	-	$50,000
Total	$165,000	$80,000	$130,000
PFIC	**NO**	**YES**	**NO**

Fair Market Value of Holdco's assets are as follows:

	Example #1	Example#2	Example#3
Cash	$50,000	$50,000	$50,000
Mkt. Securities	$40,000	$100,000	$100,000
Investment in Opco	$165,000	$80,000	$130,000
Total	$255,000	$230,000	$280,000
PFIC	**NO**	**YES**	**YES**

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The characterization of the Canadian Trust must be established as it will affect US tax reporting. The characterizations include the following:

•Grantor Trust - is defined as a Trust created by any person who makes a direct or indirect gratuitous transfer of property to a Trust which could revert to that person or pass to persons to be determined by that person (similar to Canadian reversionary Trusts). However, for a non-US grantor, the trust is a grantor trust if either the trust is revocable or the only amounts distributable from the trust during the lifetime of the grantor are amounts distributable to the grantor or the grantor's spouse.

•Non-Grantor Trust – is a Trust other than a Grantor Trust

•A foreign non grantor trust could be a "simple" or a "complex" Trust;

•A "simple trust" is a trust whereby

– all trust income must be distributed currently;
– no amounts may be paid or irrevocably set aside for a charitable beneficiary; and
– no distributions are made other than of current income (that is, there are distributions out of capital)

•A "complex trust" is a non-grantor trust other than a "simple trust".

Planning for Canadians with US Children

US Throwback Rules

•A distribution of current income to a US beneficiary of a trust is currently taxable and retains its character as ordinary income or capital gain

•Income of a domestic US trust that is not distributed currently is added to the trust capital and can be distributed later tax-free

•However, income of a foreign trust that is not distributed currently is taxable as ordinary income when it is later distributed

•Such accumulation distributions are thrown back to prior years and are subject to an interest charge under the "throwback rules"

Planning for Canadians with US Children

Tax Implications to US Beneficiaries of Canadian Trusts

If the Canadian Trust (a non Grantor Trust) has US beneficiaries several questions arise. These questions include the following:

- What is the right to income or capital of each of the beneficiaries of the Trust?
- How does this right effect the application of the US anti-deferral rules. For example, as the Trust owns shares of a Canadian company, those shares are deemed owned by a US beneficiary?

Depending on the answers to these questions, the US beneficiary can have taxable income under the previously mentioned CFC and/ or PFIC rules, even though no cash distributions from the Trust had been made.

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What do you do if you have this kind of structure?

- QEF election
- Set up Canadian ULC (An ULC is ignored or treated as a partnership for US tax purposes and as a corporation for Canadian tax purposes)
- Distribute income currently
- Set up multiple structures for resident and non-resident children.

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A Canadian tax consequence to be considered is the previously mentioned "21 year rule" and the ownership of shares by a Canadian Trust.

Deemed disposition and the 21-year rule

•Subsection 104(4) of the ITA deems a trust to have disposed of each property held by the trust for proceeds equal to the fair market value of the property on the day that is 21 years after the day on which the trust was created, and every 21 years thereafter.

•One of the planning strategies to avoid the 21-year rule, is to provide in the trust agreement generally provides that the trustees may transfer the property held by the Trust to beneficiaries prior or on the twenty-first anniversary of the trust. The transfer of the property to the beneficiaries can be completed under subsection 107(2) of the ITA to a Canadian resident beneficiary. The Trust is deemed to have disposed of the property for proceeds equal to its cost amount and the beneficiary to acquire the property at its cost amount. Unfortunately, this only applies to beneficiaries resident in Canada at the time of transfer. Subsection 107(5) of the ITA provides that the distribution of property by a trust to non-resident beneficiaries occurs on a fair market value basis.

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Some of the approaches that could be used to avoid a taxable distribution include the following:

•If the Trust document provides for same, have the non-resident establish a Canadian corporate beneficiary of which the non-resident family member is the shareholder and distribute the shares thereto. The non-resident person may consider using a ULC.

•Distribute shares to Canadian children and equalize with other assets.

•Undo the freeze and look at other planning options (including life insurance).

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Canadian Tax Consequences Upon Death and Post Mortem Planning

- Where assets are disposed of to anyone other than a Spouse or a Spousal Trust those assets are deemed disposition of assets at their fair market value.
- Consequently capital gains tax could result on any accrued gains.
- In situations where the assets include shares of a Canadian corporation double taxation could result as a consequence of a corporate liquidation.

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In planning to minimize taxation as a result of the deemed disposition rules, the following must be considered:

- Computation of the fair market value of the shares (including valuation of the underlying assets);
- Establishing the historical tax attributes of the shares including any crystallization of the enhanced capital gains exemption;
- The existence of any tax preferential accounts such as refundable dividend on hand ("RDTOH") and Capital Dividend Account ("CDA");
- Whether or not the shares are "Grandfathered" as a consequence of the stop loss rules
- The residency of the beneficiaries
- The creation of a "Trust" to complete certain tax desirable elections (such as subsection 164(6) of the ITA)

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Strategies which have been typically adopted to minimize capital gains tax as a consequence of death would include the following:

- The creation of a capital loss by the Estate resulting from a redemption of shares within its first taxation year resulting from a CDA election (Grandfathered shares);
- The creation of a capital loss by the Estate resulting from a redemption of shares within its first taxation year to recover RDTOH;
- The transfer of the shares to a newly formed company (commonly referred to as the "Pipeline" strategy);
- Any combination of the above mentioned strategies.

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In applying these strategies, attention must be given to the following Canadian tax considerations:

•Documentation to insure that the shares are in fact "Grandfathered";

•The affiliated persons stop loss rules do not apply (relief is found in subsection 40(3.61) of the ITA);

•The estate does not realize any capital gains within the first taxation year (subsection 40(3.61) of the ITA);

•That the shares do not have any "soft basis" (i.e. capital gains exemption);

•CRA's policy on the application of subsection 84(2) of the ITA to tax any distribution as a dividend rather than a tax free distribution of adjusted cost base. (MacDonald v. The Queen 2012 TCC123)

Planning for Canadians with US Children

In situations where the deceased has US resident children, the following should be considered:

•The effect of the previous planning strategies (i.e. if Canadian company will be maintained, US tax basis, the CFC/PFIC rules etc.);

•The Canadian withholding tax implications of distributions by the Estate to a US resident beneficiary (TI 2003-0020695);

•Maintain the benefit of the CDA without subjecting it to a Canadian withholding tax where there are Canadian beneficiaries;

•Benefit from the reduced withholding tax on a share redemption resulting from the previous planning;

•Possible conversion of the company to an ULC;

•The allocation of assets between beneficiaries to mitigate any potential negative US tax implication from owning shares of a Canadian corporation.

Planning for Canadians with US Children

Example

Ms. Canada is widowed with 2 children, one who lives in the US and the other lives in Canada. Her only asset is shares of a Canadian holding company with the following balance sheet:

•Cash	$1,000,000
•Marketable Securities (FMV=ACB)	$6,000,000
•Cash Surrounder Value of Life Insurance	NIL
•Total Assets	$7,000,000

In addition to this, the company has an RDTOH balance of $1,000,000

•Note: $2,000,000 of Life insurance was purchased in 1990 and one of the main purposes of the life insurance was to fund a redemption of the shares of the corporation.

Planning for Canadians with US Children

Tax Consequences Upon Demise

Deemed disposition of shares of FMV	$7,000,000
Estimated taxes	$1,687,700

Summary of Value of Estate:

Fair market value of shares	$7,000,000
Add: Life insurance proceeds	$2,000,000
Less: Estimated taxes	($1,687,700)
Net Value to Estate	**$7,312,300**

Tax Consequences Upon Demise With Planning

Estimated taxes upon demise	$1,687,700
Less: Tax benefit from capital loss carryback	
Life insurance	$2,000,000
RDTOH recovery (3x$1,000,000)	$3,000,000
Total capital loss	$5,000,000
Estimated tax savings of capital loss	$1,205,500
Add: Withholding tax on RDTOH recovery	$450,000
Estimated total taxes	$932,200

Summary of Value to Estate:

Fair market value of shares	$7,000,000
Add: Life insurance	$2,000,000
RDTOH Recovery	$1,000,000
Less: Estimated taxes	($ 932,200)
Net Value to Estate	**$9,067,800**
Increase to value of estate	**$1,755,500**

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Ownership of US Vacation Property

Ownership of US Vacation Property

Tax Considerations

- US estate tax
- Canadian income tax
- US income and withholding tax

Ownership of US Vacation Property

US Estate Tax

- US estate tax arises on the death of an individual, and could apply to a non US citizen or resident dependent upon "US situs assets" of that individual.
- The estate tax is not based on the gain resulting from the increase in value of US situs assets, but rather simply the fair market value thereof.
- The US estate tax is levied at progressive rates ranging from 18% to 35%
- US real estate owned by a Canadian constitutes a US situs asset and is thus subject to US estate tax on death notwithstanding that the owner is neither a citizen nor a resident of the US.
- Because the US estate tax is imposed on the entire value of the property and at higher rates, it could be greater than the Canadian tax resulting from the deemed disposition of the property.

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US Estate Tax

•Credits that may be available to reduce the US estate tax include the following:

i.Unified credit (function of US situs assets to that of World assets multiplied by the Unified Credit amount)

ii.Marital Credit under the Canada-U.S tax Convention

iii.Credits for State taxes

iv.Credit for estate taxes paid on prior property that has been taxed in an estate within a certain period.

Ownership of US Vacation Property

Implications to Canadians of US estate tax

- A Canadian who dies owning US real estate would be subject to capital gains tax in Canada.
- Subject to Treaty relief, a Canadian will typically look to minimize the capital gains tax by claiming the principle residence exemption.
- Article XXIV-B(6) of the Treaty does allow a foreign tax credit to be claimed in respect of US Federal and State estate taxes paid.

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Ownership of US Vacation Property

Example of US Estate Tax, Canadian Capital Gains Tax and Treaty relief:

Mr. Sunshine owns the following assets

	Example 1		Example 2	
	Cost	FMV	Cost	FMV
Florida Condominium	$ 100,000	$ 500,000	$ 100,000	$ 500,000
Other personal assets	4,500,000	$4,500,000	$6,500,000	$6,500,000
Total	$4,600,000	$5,000,000	$6,600,000	$7,000,000

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Ownership of US Vacation Property

Example 1

- US Estate Tax
  - 1. US Estate Tax based on 2011/12 rates= $155,800
  - 2. Unified Credit ($500,000/$5,000,000 x $1,730,800) = $173,080
  - 3. US Estate Tax (1-2) = NIL
- Canadian Capital Gains Tax (assuming no principal residence exemption)
  - ($500,000 - $100,000) x 24.11% = $96,440
- US estate tax cost in excess of Canadian/Provincial Capital gains tax = NIL

Ownership of US Vacation Property

Example 2

•US Estate Tax

- 1. US Estate Tax based on 2011/12 rates= $155,800
- 2. Unified Credit ($500,000/$7,000,000 x $1,730,800) = $123,629
- 3. US Estate Tax (1-2) = $32,171

•Canadian Capital Gains Tax (assuming no principal residence exemption)

- 4. ($500,000 - $100,000) x 24.11% = $96,440
- 5. Less Tax Credit claimed in Canada pursuing to article XXIX-B(6) of the Treaty = $32,171
- 6. Canadian Tax paid (4-5) = $64,269

•US estate tax cost in excess of Canadian/Provincial Capital gains tax = NIL

Ownership of US Vacation Property

Possible Ownership Structures

•There is no "one size fits all" solution to the question of ownership of a US Vacation Property. Possible ownership structures include the following;

- Individual Ownership
- Tenancy in common
- Trust
- Partnership

Ownership of US Vacation Property

Individual Ownership

- Direct ownership by the individual is simple and would entitle the owner to the lower US federal long-term capital gains rate that is available for individuals where the property is held for more than a year.
- Currently the federal rate for long-term capital gain is 15%, but is scheduled to increase to 20%.
- Direct ownership does not provide any protection against US estate tax.
- Attractive if the value of the property is modest, such that most or all of the eventual estate tax would be sheltered by the Treaty credit or the unified credit.
- Due to the simplicity of this alternative, it may be attractive to some individuals even if it results in some US estate tax.

Ownership of US Vacation Property

If Individual Ownership is desired, the following could/should be considered;

•Life insurance - Life insurance could be purchased in order to secure funds for the payment of the eventual estate tax liability.

•Ownership by lower net worth spouse - If the Canadian individual is married, it may be better if the property is owned by the spouse with the lower net worth, so as to maximize the amount of the credit available under the Treaty. It is important to consider the potential application of the Canadian attribution rules which could impact the ability to claim a foreign tax credit in the event of a profitable sale.

•Ownership by children - The funds used to purchase the property may be provided by the individual as a gift. The transfer of funds should not be made in the US, however, as the Internal Revenue Service ("IRS") may take the position that it constitutes a transfer of tangible property located in the US (i.e. a US situs asset) and is subject to the US federal gift tax. If the visits are at the convenience and discretion of the children, but if the individual's use is regular or extensive, then the individual could be viewed as having retained an implied right to use the property , which could result in estate tax inclusion.

Ownership of US Vacation Property

- Use of a Qualified Domestic Trust ("QDOT") and Marital Credit - if the purchaser of the property is a married Canadian individual, the use of a QDOT and a Canadian Spousal Trust could defer payment of estate tax to the later of the two spouses' deaths. A US marital deduction would be available for the assets that on death go to the QDOT , provided the estate makes an election to this effect.
- As an alternative to using a QDOT, it is also possible to defer a portion of the estate tax liability up to the amount of the unified credit available under the IRC until the death of the surviving spouse, by taking advantage of the marital deduction under the Treaty. This deferral is in addition to the unified credit otherwise available.
- Non-Recourse Mortgage - A non-recourse mortgage can be used in order to reduce the value of the US real property for estate tax purposes. If property is financed with non-recourse debt, only the value of the equity held by the decedent at the time of death, i.e. the value of the property less the mortgage is subject to estate tax.

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Ownership of US Vacation Property

Tenancy in Common

•Tenancy in common (i.e.: undivided co-ownership) by the spouses, and possibly together with other family members, may also be helpful in reducing US estate tax for the following reasons:

•Provides flexibility to use a QDOT and/or a bypass trust in planning to minimize US estate tax;

•In determining the value for tax estate purposes, US courts and the IRS often allow a minority discount in establishing the ownership value.

•Each of the co-owners must contribute funds for the purchase of the property to avoid any negative impact of the Canadian attribution rules .

•Joint tenancy with right of survivorship which is often used in Canada, should be avoided.

Ownership of US Vacation Property

Trust

A properly structured Canadian discretionary inter vivos trust can be used as a vehicle for holding US real estate without incurring US estate tax. It is important to ensure that the US real estate would be purchased directly by the Trust with funds provided by the Canadian Settlor rather than being transferred to it. However, the following must be considered:

- The Canadian Settlor individual should not be a trustee or beneficiary of the Trust, as an interest in the Trust, even if only a discretionary one, coupled with the use of the Trust property by the settlor/contributor could be viewed as a "retained interest" and thus included in the US estate of the settlor/contributor.
- If some of the beneficiaries of the Trust are also trustees, they cannot participate in any decisions relating to the distribution of property under the Trust to prevent a finding that those assets have become part of their estate.

Ownership of US Vacation Property

- The IRS has held that the rent-free use of the property by the settlor by virtue of being married to a beneficiary does not constitute a retained interest for estate tax law purposes. For Canadian tax purposes, there should be no taxable benefit conferred on the beneficiaries of the Trust, since CRA takes the position that no benefit should be assessed where personal use property is owned by a trust.
- US real estate owned would be taxed in the US at the lower capital gains tax rate for individuals.
- Consideration should be given to the "21 year rule" under Canadian tax law, whereby a deemed disposition occurs on the 21st birthday of a trust.
- The disadvantage of ownership through a trust is that the Canadian resident must give up ownership and control of the property in favor of his or her spouse and children.

Ownership of US Vacation Property

Canadian Limited Partnership

A Canadian limited partnership can also be used to hold US real estate, with the individual as the limited partner and a corporation wholly owned by the individual as the general partner. However, the following must be considered:

-Attention must be paid to meeting the requirements for the existence of a partnership under the law of the Canadian province where the partnership would be created. In the province of Quebec, a partnership exists where the parties carry on an activity together with a profit motive. Holding personal use real estate may not be sufficient to meet the "for profit" requirement, as it can be argued that the purpose of the partnership is to provide one of the partners with the use of a vacation home rather than to invest in income earning real estate.

-An important planning concern is whether the partnership should check the box to be treated as a corporation for US tax purposes. The IRS does not have a clear policy as to the situs of a partnership interest, such that if the partnership does not check the box, a possibility exists that the IRS could find the partnership interest to be situated where the partnership's assets are located, namely in the US. The option of not checking the box has the advantage that the lower capital gains rate for individuals (currently 15%) would be available on the eventual sale of the property.

Ownership of US Vacation Property

Substantial Presence

•U.S citizens must file tax returns to report their worldwide income

•According to the IRS a US resident includes:

- a green card holder, or
- someone who meets the ***substantial presence*** test

•To determine US residency for the current year under the substantial presence test compute the sum of:

- the number of days present in the US in the current year, plus
- 1/3 the number of days present in the US in the preceding year, plus
- 1/6 the numbers of days present in the US in the second preceding year.

•If this totals 183 days or more, and the individual spent more than 31 days in the US in the current year, you have met the substantial presence test and are considered a US resident, unless you qualify for the "*Closer Connection Exception*"

•An individual qualifies for the closer connection exception if:

- the individual is present in the US in the current year for less than 183 days,
- the individual maintains a tax home a foreign country during the current, and
- the individual has a closer connection to a single foreign country in which he maintains a tax home.

•A tax home is the country where the individual's home and principal place of business are.

•To escape US residency status under the Closer Connection Exception form 8840 must be filed by April 15th

•No tax return is required and no taxpayer ID number is necessary to file this form.

•This form must be filed each year

Ownership of US Investment Real Estate

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Ownership of US Investment Real Estate

Considerations in Selecting Investment Structures

- US estate tax implications;
- Liability protection against commercial risks;
- US / Canadian income tax implications;
- Funding alternatives (corporate/personal available funds);
- US filing requirements

Ownership of US Investment Real Estate

Common US Real Estate Investment Structures

- Personal ownership
- Canadian corporate ownership
- US corporate ownership
- Limited Partnership
- Canadian Trust

Ownership of US Investment Real Estate

Personal Ownership

•Provides no protection from US estate tax

•Provides no protection from commercial risks.

•Unless the individual files an election with the IRS to be taxable on net rental income (IRC 871(d)), US rental income is subject to a 30% withholding rate based on the gross rent paid.

•The election requires the Canadian individual to file a US tax return allowing the individual to pay US tax based on the net rental income computed for US tax purposes.

Ownership of US Investment Real Estate

- Depreciation is not a discretionary deduction for US purposes and the building must be depreciated on a 27.5 year straight line basis for residential rental property and 39 years for non residential property.
- Individuals will also report the net rental income in Canada, by applying Canadian tax rules (such as capital cost allowance as opposed to US depreciation)
- Foreign tax credits are available in respect of the US tax paid on the net rental income
- The more favorable US long term capital gains tax rates would apply to a profitable sale (currently 15% proposed to increase to 20%)
- In calculating the capital gain for US tax purposes, the tax cost of the property is reduced by any depreciation claim allowed.

Ownership of US Investment Real Estate

US Corporate Ownership

- If owned by an individual the shares would be subject to US estate tax.
- Would provide liability protection to the individual.
- The US corporation will be liable for US corporate tax on both income earned from the property and on any capital gains realized on disposition.
- The US corporation will not benefit from the preferable long term capital gains tax rates (and possibly subject to additional State tax)

Ownership of US Investment Real Estate

- There will also be additional withholding tax as dividends are paid to the Canadian shareholder (5%-15% depending on ownership)
- If the US corporation is a controlled foreign affiliate ("CFA"), the shareholder would be required to calculate the foreign accrual property income ("FAPI") of the US corporation and include this amount yearly in income.
- If the US corporation is not a CFA, the shareholder would be required to include in income any dividend distributions.
- In both these situations (FAPI and dividend) foreign taxes will be considered
- Potential for double taxation in the event of death (deemed disposition of shares without underlying basis increase)

Ownership of US Investment Real Estate

Canadian Corporate Ownership

- Protects against US estate tax.
- Would provide liability protection to the individual.
- Unless the corporation files an election with the IRS to be taxable on net rental income (IRC 882(d)), US rental income is subject to a 30% withholding rate based on the gross rent paid.
- Net rental income, taxable capital gains and recapture are taxable both in Canada and the US, with foreign tax credits available in determining the Canadian tax liability.
- Canadian corporation does not benefit from the preferable US long term capital gains tax rates as for individuals.
- Distributions to the shareholder could also be subject to US withholding tax of up to 5% for branch profits tax.
- Foreign tax credits claimed by the Canadian corporation will reduce the refundable dividend tax on hand thus increasing overall taxes on a full distribution.
- Potential for double taxation in the event of death (deemed disposition of shares without underlying basis increase).

Ownership of US Investment Real Estate

Limited Partnership Ownership

•The treatment of a Canadian limited partnership for U.S estate tax purposes is uncertain.

•Protects non active partners from liability.

•The taxation to an individual partner would be similar to that previously mentioned to an individual (including withholding requirements and the IRC 871(d) election). However, the ability of a partner to benefit from the reduced withholding tax rates may be limited.

•The preferable US long term capital gains tax rates would be available to an individual partner.

•The use of a limited partnership would result in the perfect integration unlike corporate ownership unless the Partner is a Corporation in which case the previous comments on Corporate Ownership would apply.

Ownership of US Investment Real Estate

Canadian Trust Ownership

- Does provide individual beneficiary liability protection.
- However does not provide the Trustee(s) protection (often a family member).
- May provide protection from US estate tax.
- The same withholding tax and elections would be required as that of a Canadian corporation.
- Would be subject to tax in Canada at either the top marginal rates of the Trust or the individual marginal rates of the beneficiaries.
- The more favorable US long term capital gains tax rates would apply to a profitable sale (currently 15% proposed to increase to 20%).
- The 21 year rule must be considered.

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Ownership of US Investment Real Estate

US Entity Classifications

Limited Liability Corporations (LLC)

•Taxed as Partnership for US tax purposes.

•Taxed as a corporation for Canadian tax purposes.

•Does not benefit from all Treaty relief.

•Could lead to excessive taxation as a consequence of the above.

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Ownership of US Investment Real Estate

Limited Liability Limited Partnership

•No partner liability.

•May be classified by CRA as a Corporation similar to that of an LLC.

•Could have the same result of that of an LLC.

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In accordance with Internal Revenue Service Circular 230, we advise you that unless otherwise expressly stated, any discussion of a federal tax issue in this communication or in any attachment is not intended to be used, and it cannot be used, for the purpose of avoiding federal tax penalties.

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