BUCHANAN BARRY LLP
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TAX NEWSLETTER
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REAL OPPORTUNITY: CANADIANS & U.S. REAL ESTATE

The weak U.S. economy, the recent subprime mortgage crisis and the strength of the Canadian dollar relative to the greenback have all combined to make purchasing U.S. real estate relatively attractive. Many Canadians are now actively searching for that vacation home in the south they have long dreamed of or are contemplating an investment in a market many have suggested will rebound.

Whatever their reasons, Canadians have more to consider than condo fees and catamarans when buying a property in the U.S. Among other things, the potential Canadian **and** U.S. tax implications of such a purchase require attention.

The Perfect Structure

Given the complexities of both the Canadian and U.S. tax regimes, it should come as no surprise that there is no single perfect structure through which to acquire and hold U.S. real estate. As discussed below, tax practitioners favour different structures for different situations. But first, let's consider the basics.

Resident of Canada: Alien in the U.S.

Residents of Canada are subject to Canadian income tax on their worldwide income. Where a Canadian resident is simultaneously subject to income tax in another country, that person generally receives relief from double-taxation through a "foreign tax credit" or foreign tax deduction, as well as any additional relief provided for in any applicable tax treaty between Canada and the other country.

Unless a Canadian resident is also a resident or citizen of the U.S., the U.S. *Internal Revenue Code* defines that person as a "nonresident alien". Nonresident aliens are subject to tax in the U.S. but only on a limited basis: primarily tax on income earned from property located in the U.S. as well U.S. Estate and Gift Taxes.

Canada

For Canadian tax purposes, a Canadian resident who owns a U.S. vacation or investment property is treated in much the same way as though that property were located in Canada:

- If a vacation property is acquired purely for personal use, there should be no income tax implications, save taxation of any capital gain upon disposition (or deemed disposition on death); and

- If the property is acquired for investment purposes, any rental income would be subject to tax in Canada, as would any capital gain realized upon disposition (or deemed disposition on death).

In fact, the main difference between Canadian tax treatment of income and/or gains from a U.S. property (as compared to a domestic property) lies in the requirement to report U.S. federal and state taxes in the Canadian income tax return to obtain any available "foreign tax credit" or foreign tax deduction. Also, if the U.S. property exceeds $100,000 in value, an individual Canadian resident owner must disclose it in his or her annual tax return.

United States

If a U.S. vacation property is held solely for personal use, a Canadian resident (a "nonresident alient" in the U.S.) need not be concerned about U.S. income taxes or the need to file a U.S. income tax return, unless the property is sold during their lifetime. If sold at a gain, the nonresident alien will be subject to federal and (possibly) state income taxes on that gain. Depending on the state where the property is located, the purchaser may also be required to withhold 10% of the purchase price and remit that amount to the *Internal Revenue Service*. When selling, the nonresident alien must file a U.S. income tax return to report the sale, regardless of whether or not they realize a gain.

If the U.S. property is used to generate rental income, the person paying the rent is obliged to withhold and remit 30% of the gross rent to the *Internal Revenue Service* on behalf of the nonresident alien. The non-resident alien may choose not to file a U.S. income tax return and simply forego any savings of the 30% withheld.

However, if there are sufficient deductible expenses tied to the rental income, the nonresident alien may choose to file a U.S. income tax return to report and pay tax on the net rental income. In such a case, the nonresident alien should provide a particular withholding waiver to its tenant prior to collecting any rent so as to avoid the 30% withholding above.

Death & Taxes

As described above, buying and selling, or buying, renting and selling a U.S. property poses relatively few problems for Canadian residents/nonresident aliens. The situation becomes somewhat more complex – and more costly – when the Canadian resident/nonresident alien dies while owning the U.S. property. Unlike Canada, which provides for a deemed disposition and taxation of accrued capital gains on death, the U.S. imposes a direct "Estate Tax" at relatively high rates on the fair market value of the property.

The magnitude and mechanics of the U.S. Estate Tax often bear heavily on the decision as to how to hold U.S. property.

Estate Tax is imposed at marginal rates depending on the decedent's marital status, the value of his or her worldwide estate, the proportion of that estate inside the U.S. and the year in which the individual dies.

Determining the Estate Tax liability on a U.S. property for a Canadian resident/nonresident alien begins by comparing the fair market value of the U.S. property with the fair market value of the decedent's worldwide estate. This ratio will determine what proportion of the "Unified Credit" – an exemption from Estate Tax – is available. The available Unified Credit depends on the year in which it is claimed.

Example

Consider Bob, a bachelor, who is a Canadian resident for Canadian income tax purposes and a nonresident alien for U.S. tax purposes. After years of enjoying his $1,500,000 Florida vacation home during the late winter months and his $1,500,000 home in B.C.'s interior during the rest of the year, Bob dies in October of 2008. Upon death, Bob has no additional assets and bequeaths his entire estate to his niece.

Based on the foregoing facts, Bob's Estate Tax would be approximately $165,400.

Planning for the Estate Tax is even more complex because of how it is slated to change. For instance, the current marginal Estate Tax rates will also apply in 2009, although the maximum available Unified Credit is slated to nearly double ($1,455,800 in 2009, up from $780,800 in 2008). Under the current legislation, the Estate Tax is scheduled to be repealed in 2010 – making that the best year to die! But the repeal must be "renewed", failing which 2011 will see the Estate Tax come back with a vengeance: substantially higher marginal rates on estates over $1,250,000 (up to 55%) and a maximum Unified Credit worth less than half its value in 2008 ($345,800 in 2011 and subsequent years). Many commentators do not believe the 2010 repeal will be renewed given the U.S. Treasury's current fiscal problems and the politically charged nature of the Estate Tax. In fact, it is possible the current legislation itself may be changed to give the Estate Tax greater weight in 2009 and 2010.

Example

Factoring in these expected changes to the Estate Tax, let's consider Bob again: if Bob were to die in 2011, his Estate Tax liability would be approximately $382,900, using the same numbers mentioned above.

Other Credits & Deduction

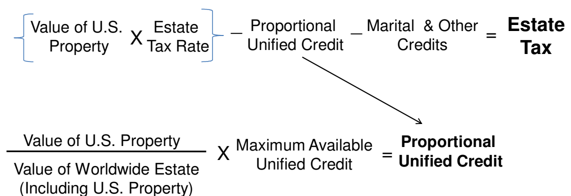
Canadian residents who are married may also obtain an additional credit against their Estate Tax liability. This credit, called the "Marital Credit" is calculated in the same fashion as the Unified Credit, with the result being entitlement to twice the Unified Credit.

A decedent (regardless of marital status) is also generally entitled to deduct from his or her Estate Tax all or a portion of the Estate Tax previously paid by another decedent who transferred the property to the first decedent within the past ten years.

The following table provides the Estate Tax rates and maximum available Unified Credit for 2008, 2009, 2010, 2011:

<table>
<tr><th>Threshold (USD)</th><th>2008/09</th><th>2010</th><th>2011</th></tr>
<tr><td>$0-$10K</td><td>18%</td><td rowspan="18">Repealed</td><td>18%</td></tr>
<tr><td>$10K-$20K</td><td>20%</td><td>20%</td></tr>
<tr><td>$20K-$40K</td><td>22%</td><td>22%</td></tr>
<tr><td>$40K-$60K</td><td>24%</td><td>24%</td></tr>
<tr><td>$60K-$80K</td><td>26%</td><td>26%</td></tr>
<tr><td>$80K-$100K</td><td>28%</td><td>28%</td></tr>
<tr><td>$100K-$150K</td><td>30%</td><td>30%</td></tr>
<tr><td>$150K-$250K</td><td>32%</td><td>32%</td></tr>
<tr><td>$250K-$500K</td><td>34%</td><td>34%</td></tr>
<tr><td>$500K-$750K</td><td>37%</td><td>37%</td></tr>
<tr><td>$750K-$1M</td><td>39%</td><td>39%</td></tr>
<tr><td>$1M-$1.25M</td><td>41%</td><td>41%</td></tr>
<tr><td>$1.25M-$1.5M</td><td>43%</td><td>43%</td></tr>
<tr><td>$1.5M-$2M</td><td rowspan="5">45%</td><td>45%</td></tr>
<tr><td>$2M-$2.5M</td><td>49%</td></tr>
<tr><td>$2.5M-$3M</td><td>53%</td></tr>
<tr><td>$3M-$3.5M</td><td rowspan="2">55%</td></tr>
<tr><td>$3.5M +</td></tr>
<tr><td>Unified Credit</td><td>$780,800 / $1,455,800</td><td></td><td>$345,800</td></tr>
</table>

The following diagram illustrates the Estate Tax calculation:



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Gift Tax

For those who attempt to avoid the Estate Tax by transferring U.S. property prior to death for nominal consideration, the Estate Tax is merely replaced by the "Gift Tax". The Gift Tax – designed to frustrate avoidance of the Estate Tax – is imposed at rates similar to the Estate Tax and paid by the transferor. While U.S. citizens and U.S. residents have certain lifetime exemptions from the Gift Tax, the same is not true for nonresident aliens.

The "Generation-Skipping Tax" is similar to the Estate and Gift Taxes, save that it is triggered when a transfer is made to a person two or more generations below the transferor (such as the grandchild of the transferor). The lifetime exemptions from the Generation-Skipping Tax available to U.S. citizens and U.S. residents are not available to nonresident aliens.

Non-recourse Mortgage

Before considering various structures which may mitigate U.S. Estate Tax, let's consider one simple method that has proven effective: the non-recourse mortgage.

A non-recourse mortgage is a financing instrument where the lender's security and collection rights are limited to the collateral posted by the borrower. Under such an arrangement, the borrower is not personally liable for any debt in excess of the value of collateral.

Non-recourse mortgages are effective Estate Tax avoidance methods because any outstanding balance of such a mortgage is deducted from the fair market value of the U.S. property for purposes of calculating the Estate Tax liability thereon. As the fair market value of the U.S. property serves as the "base" upon which Estate Tax and the available Unified Credit are calculated, reducing the fair market value of the U.S. property directly reduces a decedent's Estate Tax liability.

For Canadian tax purposes, interest is generally deductible if the borrowed funds are used to generate income (regardless of how the loan is collateralized). Accordingly, a Canadian resident who acquires a U.S. property with his or her personal resources and then obtains non-recourse mortgage financing to reduce their Estate Tax exposure may consider investing the loan proceeds to earn income. The result of such a strategy would be mitigation of the individual's Estate Tax exposure while giving rise to an interest deduction in calculating the individual's annual Canadian income tax liability.

Ownership Alternatives

Corporation

Until a few years ago – 2005 to be exact – Canadian residents were generally advised to hold their U.S. vacation properties through a Canadian corporation because Estate Taxes cannot generally touch U.S. property when held by a foreign corporation. Until December 31, 2004 (and still for those corporations in place at that time), corporations whose sole purpose was to hold U.S. vacation properties were exempted from the shareholder benefit rules that otherwise plague shareholders who avail themselves of corporate assets. These exemptions, however, were lifted effective January 1, 2005.

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Now, holding a U.S. vacation property through a Canadian corporation is generally not desirable because of the shareholder benefit rules which assess shareholders a benefit in respect of their use of corporate property (unless the shareholders pay the corporation a fair market value rent).

Although shareholder benefits are not really a concern in the context of a corporately owned investment property, higher U.S. corporate tax rates on both income and capital gains generally make corporate ownership less desirable than the alternatives.

Personal Ownership

But for Estate Tax, personal ownership of U.S. vacation or investment properties is generally more desirable than the alternatives. Personal ownership avoids the cost and inconvenience associated with introducing new entities and reporting for them. Personal ownership also avoids the relatively high U.S. corporate tax rates on income and capital gains from U.S. property.

However, mortality has its cost and, in the U.S. a large part of this cost is the Estate Tax.

Where couples or partners are purchasing a U.S. property, consideration must be given as to whether the property will be held by the couple as joint tenants or as tenants in common. An examination of the differences in the tax treatment of joint tenancy and tenancy in common is beyond the scope of this newsletter, however, as there are meaningful tax and legal implications associated with each, consideration should be given prior to concluding the purchase.

Canadian Discretionary Trust

A Canadian discretionary trust may be a useful way for a wealthy individual or couple to mitigate their Estate Tax liability. Through the trust, Estate Tax is deferred until the death of the beneficiaries of the trust. A trust structure is not without complications and will likely not be desirable unless the ratio of the value of U.S. property to the individual or couple's worldwide estate is so small that the available Unified Credit absorbs only a small portion of a large Estate Tax liability.

A typical situation involves two wealthy parents who settle a discretionary trust prior to closing the purchase of the U.S. property; in fact, the trust uses the parents' money to purchase the U.S. property. The parents are generally excluded as beneficiaries of the trust; rather the parents' child or children are named. Exclusion as a beneficiary means that the parents will have ceded all ownership rights to the U.S. property (and the funds used to acquire it), and must conduct themselves around the trust in such a way that the *Internal Revenue Service* cannot argue Estate Tax should be paid upon their deaths. For instance, this could go as far as requiring the parents pay the trust a fair market value rent for their use of the U.S. property.

It is generally desirable to avoid generating income and/or capital gains in the trust because of the various U.S. and Canadian compliance obligations, as well as potential taxable benefits. Consideration must also be given to the Canadian 21-year deemed disposition and attribution rules.

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Canadian Partnership

Some tax practitioners advocate the use of a Canadian partnership to reduce Estate Tax risk on U.S. property. Most are agreed that a partnership structure is generally more risky than the alternatives and may result in higher income taxes, especially if the partnership "checks-the-box" to be treated as a corporation in the U.S.

Conclusion – Structure

Despite a plethora of options, there is no single ownership structure favourable to all situations. Accordingly, **you should speak with your Buchanan Barry tax advisor well in advance of concluding that offer to purchase.**

Other Considerations

State, Local & County Taxes

Various states, counties and communities impose different taxes on nonresident aliens than those imposed on residents. For example, property taxes in Florida are generally higher for nonresident aliens than they are for U.S. residents.

Insurance

If Estate Tax is altogether unavoidable, it may be desirable to insure against the liability. Life insurance can be costly for those over 40 years of age, so careful consideration of all scenarios is necessary before signing the policy forms.

Income vs. Capital Gains

Throughout this newsletter we have discussed the tax treatment of capital gains upon disposition of a U.S. property. It should be noted, however, that capital treatment is not always available where a property is sold. Accordingly, consideration must be given to the tax consequences of re-characterization of a capital gain as constituting a business or trade profit.

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Buchanan Barry LLP has served the Calgary business and non-profit community since 1960. We are a full-service chartered accounting firm providing accounting, audit, assurance, advisory, tax and valuation services to clients in the oil and gas sector, the service industry, real estate, the retail and wholesale trade, the manufacturing industry, agriculture, the non-profit sector and professionals.

Should you have any questions regarding the foregoing or other tax matters, please do not hesitate to contact members of our tax group at (403) 262-2116.

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