

Tax Implications of Owning a U.S. Property

A consequence of the recent depression in the housing market in the United States has been an increase in the number of Canadians purchasing properties down south for their personal use. While most Canadians recognize that there are income tax implications with respect to such purchases, very few are aware that they may also be exposed to US estate tax upon their death. This article will provide an introduction to the U.S. estate tax and its effect on Canadian owners of U.S. property. We will also discuss some of the ownership structures available to Canadians. Many U.S. states also impose their own estate taxes; however, these are beyond the scope of this article.

Overview of the U.S. Estate Tax:

Unlike Canada, the U.S. tax regime does not have deemed disposition rules on a taxpayer's death by which capital gains arise by virtue of a disposition of property at fair market value. The U.S. estate tax is calculated on the fair market value of the taxpayer's assets at death and ignores the underlying cost of the relevant property. While U.S. citizens and residents are taxed on the fair market value of their worldwide assets held at the date of death, Canadian residents who are not U.S. citizens are only taxed on the fair market value of U.S. situs assets owned at death. Examples of U.S. situs assets include the following:

- U.S. real property;
- Stock of corporations organized in or under U.S. law. This will include shares of a U.S. corporation held in a Canadian account (registered or non-registered);
- Tangible property located in the U.S. (cars, boats, etc.);
- U.S. bonds and debentures; and
- U.S. pension plans and annuities.

For 2009, the maximum U.S. estate tax rate is 45% and a credit of \$1,455,800 (all monetary references in this



article are to U.S. dollars) is available to reduce U.S. estate tax. This credit thereby exempts from U.S. estate tax any estate worth \$3.5 million or less. Currently the top estate tax rate is scheduled to drop to 0% in 2010 and return in 2011 with a top rate of 55% with the exemption level reduced to \$1 million. The U.S. Congress is currently considering modifications to the U.S. estate tax but no consensus has been reached. There is uncertainty as to the U.S. estate tax rates and exemption that will apply in future years. However, it is very unlikely that no U.S. estate tax would be applicable for 2010.

Under the Canada-U.S. tax treaty, the credit is available to reduce the U.S. estate tax of a Canadian resident and citizen. However, the credit is pro rated based on the fair market value of U.S. property held at the date of death against the fair market value of a Canadian's overall estate.

The following example illustrates the application of the U.S. estate tax on a Canadian resident and citizen:

Value of U.S. property at death	-	\$1,000,000
Gross value of estate	-	\$5,000,000

Canadian resident and citizen dies in 2009

In our example above, the credit available to the estate would be limited to \$291,160 [$\$1,455,800 \times (\$1,000,000/\$5,000,000)$]. Based on the fair market value of U.S. property of \$1,000,000, the basic U.S. estate tax

would be \$345,800. After applying the available credit of \$291,160, the net U.S. estate tax would be \$54,640.

Another credit available to a Canadian resident and citizen under the Canada-U.S. tax treaty is the marital credit. The marital credit, which effectively doubles the credit discussed above, applies where U.S. property is transferred on death to a spouse and such a transfer would have qualified for the U.S. marital credit had the surviving spouse been a U.S. citizen. In the example above, U.S. estate tax would be avoided entirely assuming that the U.S. property was transferred directly to a spouse on death.

An important benefit, for a Canadian taxpayer, under the Canada-U.S. tax treaty is the ability to claim a foreign tax credit for U.S. estate tax paid. The Canadian tax resulting on the capital gain triggered on the deemed disposition of U.S. property can be offset by the U.S. estate tax attributable to such property.

U.S. estate tax is calculated by filing Form 706-NA which is due nine months after the date of death. The filing date may be extended (at the discretion of the Internal Revenue Service), but the tax is due on the nine month filing due date. There are provisions that permit installment payments of the tax, however an arrangement must be requested and approved by the U.S. tax authorities.

Potential Ownership Structures:

The exposure to the U.S. estate tax can be reduced or eliminated depending to the ownership structure of U.S. property. Ownership structures which are usually considered include:

- Personal ownership with non-recourse mortgage;
- Ownership by a Canadian corporation; and
- Ownership by a Canadian trust.

Personal Ownership With Non-recourse Mortgage:

A non-recourse mortgage is collectible only against a specific property and not against any other asset of the individual. For U.S. estate tax purposes, the value of a non-recourse mortgage on U.S. real estate is netted against the value of the property in the determination of U.S. estate tax. In our previous example, if a non-recourse mortgage of \$500,000 existed against the property, the value of the U.S. property for estate tax purposes would be \$500,000 and would attract gross estate tax of \$155,800. The credit available would be \$145,580 [$\$1,455,800 \times (\$500,000/\$5,000,000)$] resulting in net U.S. estate tax of \$10,220. This strategy would therefore reduce U.S. estate tax by approximately \$44,400.

The implementation of this strategy does not require that the mortgage proceeds be used to purchase the

property. If the funds borrowed against the property are used for investments purposes, the interest paid on the borrowings may be deductible for Canadian tax purposes.

The following issues must be considered in connection with this strategy:

- Most commercial lenders will lend on a non-recourse basis as a factor of the underlying property value. In most cases, the loan may be capped at 50% to 60%. Therefore, it will not be possible to offset the full value of the property for U.S. estate tax purposes.
- The amount of estate tax savings will decrease if the property appreciates in value or if the loan requires principal repayments.
- The interest cost of the loan must be considered, especially if the interest is not tax deductible.
- The loan arrangements may lead to some interest rate risk based on the relevant borrowing terms.

Ownership by a Canadian Corporation:

In the past, a Canadian corporation was often used to own a U.S. property. The corporation, if properly structured, was considered to eliminate U.S. estate tax on death of the shareholder, and shareholder benefit issues did not arise due to an administrative position of the Canada Revenue Agency. This type of corporation was referred to as a single-purpose corporation. However, the Canada Revenue Agency withdrew its administrative policy effective January 1, 2005. The implication of this withdrawal is that a taxable shareholder benefit will now be created if a property held by a corporation is available for the personal use of a shareholder. The value of the taxable benefit will normally be determined under one of two approaches: the fair market rent approach or the imputed rent approach. Under the fair market rent approach, the taxable benefit will be the fair market value rent for the property less any consideration paid by the shareholder to the corporation for the use of the property. Under the imputed rent approach, the taxable benefit will be calculated as follows:

The greater of the cost and the fair market value of the property X the Canada Revenue Agency's prescribed interest rate
 + the operating costs related to the property paid by the corporation
 - any consideration paid by the shareholder for the use of the property.

Notwithstanding the change in the Canada Revenue Agency's administrative policy, there has always been a concern that the Internal Revenue Service could challenge a single-purpose corporation structure. Further, a major problem with holding U.S. real property in a corporation is a higher U.S. tax exposure if the property is sold (prior to death) at a gain. Specifically, an individual's gain on the sale of U.S. real estate may be subject to a maximum capital gains tax rate of 15% (for U.S. tax purposes) while a corporation is taxed on capital

gains at the regular U.S. corporate tax rates which can be as high as 35%. The overall tax paid in Canada will also be higher in the corporate setting as tax will be paid at the corporate level and then the shareholder will have to pay tax when the funds are distributed as a dividend. Based on the above comments, a corporation may not be an advisable structure for purposes of holding a U.S. property.

Ownership by a Canadian Trust:

A Canadian trust may also be used to own a U.S. property. If properly established, the trust will avoid any exposure to U.S. estate tax. In particular, the trust must be set up before the purchase of the U.S. property and the person who provides the funds to the trust for the purchase must not be a trustee or a beneficiary of the trust. The most common structure is where one spouse creates the trust (the grantor) while the other spouse and their children are named the beneficiaries of the trust. The grantor's spouse and their children can then use the property rent-free during their lifetimes. The property held by the trust would not be included in the grantor's estate for U.S. estate tax purposes, nor will it be included in the spouse's estate for U.S. estate tax purposes on his or her death.

Using a Canadian trust to own U.S. property does have its disadvantages. If the grantor's spouse predeceases the grantor, the grantor must pay fair market value rent to the trust for the property to be excluded from his or her estate for U.S. estate tax purposes. For Canadian tax purposes, a trust is deemed to dispose of all of its capital property on the twenty-first anniversary date of its creation and every twenty-one years thereafter. Proper planning can negate any adverse tax consequences resulting from this deemed disposition rule.

U.S. Tax Considerations on Sale of the Property:

While we have concentrated on the U.S. estate tax implications of owning property in the U.S., Canadians should also be aware of the tax implications should they decide to sell the property in the future. A sale of a U.S. property by a Canadian resident and citizen will require the filing of a U.S. non-resident tax return for the year of disposition. The purchaser of the property will be required to withhold and remit 10% of the gross proceeds to the Internal Revenue Service as a withholding tax. For purposes of the withholding reporting and the filing of the U.S. non-resident tax return, a U.S. Taxpayer Identification Number must be applied for by the Canadian seller prior to the disposition of the property. For Canadian tax purposes, the U.S. tax paid on the capital gain resulting from the disposition of a U.S. property can be claimed as a foreign tax credit to reduce the Canadian tax payable on the gain.

This article has addressed the U.S. estate tax and income tax issues that should be considered in the decision to

purchase a U.S. property. With proper planning prior to the acquisition of the U.S. property, the exposure to these taxes can be significantly reduced.

Welch LLP can also assist with the U.S. tax compliance related to the disposition of a U.S. tax property or U.S. estate tax.

For more information about the tax implication of purchasing a U.S. property contact a professional at Welch LLP or visit us at: www.welchllp.com.

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