2016 TSG CONFERENCE

Woops, My U.S. Real Estate is in a U.S. Corporation
How to Make the Most of a Bad Situation

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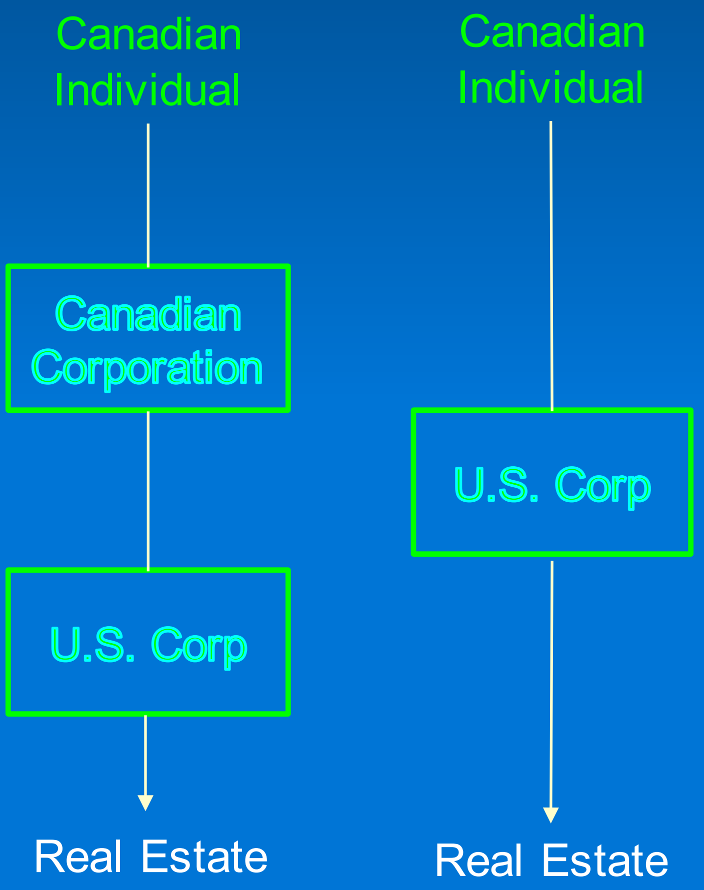
How to Make the Most of a Bad Situation

- Why Woops?
- How is rental income and gains on disposition taxed in the U.S. and in Canada?
- What, if anything, can be done?

U.S. Tax Considerations

- Taxation of rental income
- Repatriation:
  - Net income and profits
  - Refinancing proceeds
- Taxation of disposition of U.S. Corp. Stock
- Taxation of disposition of real property
- Gift tax
- Estate Tax
- Privacy Concerns / Tax filings



U.S. Taxation of Rental Income

- Rental income taxed on net basis at corporate rates
  - 34% up to $10 million
  - Thereafter 35%
  - Compare with individual rate at 39.6% on net income or 30% withholding on gross passive income
- Distribution of net income may be subject to dividend withholding tax at 30%
  - Under the Canada – U.S. tax treaty individual shareholder may be eligible for reduced rate of 15% and a corporate shareholder may be eligible for a 5% withholding
- Personal use property – charge rent?

U.S. Taxation at Disposition of Stock

- Stock in a U.S. corporation owning real property is treated as U.S. Real Property Interest ("U.S.R.P.I.")
- Disposition of U.S.R.P.I. is taxable under F.I.R.P.T.A.
  - Buyer must withhold tax under F.I.R.P.T.A.
  - Dispositions after February 16, 2016 will be subject to 15% withholding if the consideration is in excess of $1 million

U.S. Taxation at Disposition of Real Property

- No preferential rate for capital gains
- Gain taxed at a maximum rate of 35%
  - Compare with non-U.S. individual or foreign trust that would be subject to 20% tax at disposition
- Distribution of net profits will be subject to withholding tax
  - Dividend to extent of earnings and profits
  - Capital gain treatment in excess of adjusted basis
    - For an individual – 20%
    - For a corporation – 34% / 35%
  - If the shareholder is a corporation, U.S. Corp. may liquidate without additional tax after property was disposed of at a taxable transaction and certain steps taken

Privacy/Reporting

- U.S. Corp will have reporting obligations
- Canadian individual or corporation required to file information return with the I.R.S. if owns 25% or more in U.S. Corp. (Form 5472)
- Canadian individual holding U.S. Corp through Canadian Corp. is not subject to reporting in the U.S.
- Canadian Corp. has to comply with F.A.T.C.A.
  - If Canadian Corp. is family owned, not professionally managed, and solely owns stock of U.S. Corp, likely a Passive N.F.F.E.
    - U.S. persons who hold equity or debt would need to be reported to Canadian tax authorities under the I.G.A.

U.S. Gift Tax

- Non-resident aliens (NRA) are taxed on gifts of tangible (but not intangible) property located in the United States
  - Gift of U.S. real property is subject to gift tax
  - Gift of stock (whether domestic or foreign corporation) is *not* subject to gift tax
  - Gift of partnership interest probably *not* subject to gift tax

U.S. Gift Tax Considerations

- "Substance over form" risk
  - Donee or trust is funded with cash and purchases real property from grantor (*Davies v. Commissioner*, 40 T.C. 525 (1963))
  - Foreign owner contributes property to partnership, then makes gift of partnership interest

- ❖ If gift is taxable, no unified credit for nonresidents
- ❖ No step-up in basis on *inter vivos* gift

U.S. Estate Tax

- Estate of NRA is subject to estate tax on property located in the United States, including intangible property
  - U.S. real property and tangible property located on it
  - Stock in U.S. corporation (publicly traded or not)
 - First $1 million subject to graduated tax; Thereafter tax rate is 40%; unified credit equivalent to $60,000 exemption (unchanged for decades)
 - The Canada – U.S. treaty allows some Canadian to shield up to $5.45 million from U.S. estate tax
 - Stock in foreign corporation <u>are not</u> subject to U.S. estate tax
- Uncertain treatment of partnership interests
  - I.R.S. position: interest is located in the U.S. if partnership is engaged in U.S. trade or business
    - What if partnership owns only residence for NRA's personal use?
  - Other theories: place of organization or partner domicile

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Why Woops?

<u>Canadian Implications - Individual Shareholder</u>

Rental Income - FAPI

- Foreign Accrual Property Income (FAPI) while earned. CCA may be claimed based on Canadian rules.
- Deduction equal to 2.2 x U.S. taxes paid.
- Excess is taxable as ordinary income.

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Canadian Implications - Individual Shareholder

Rental Income - FAPI

- Assumed U.S. tax is 40%, effective rate for Ontario resident on FAPI is 46.42%.
- Effective rate should be lower in provinces with lower tax rates. Example provided in notes page.
- Foreign reporting – T1134
- This is not the end of the story.

How to Make the Most of a Bad Situation

Canadian Implications - Individual Shareholder

Rental Income – Distribution as Dividends

- Dividend subject to U.S. withholding tax – 15%
- Dividend less FAPI previously taxed is treated as ordinary income taxable in Canada
- FTC for withholding tax paid

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Canadian Implications - Individual Shareholder

Rental Income – Distribution as Dividend

Additional tax on distributions is $16.68

- Overall tax is $72 ($16.68 + $46.42) on $100 rental income. See example in notes page.
- If property was owned directly, highest rate would be 53.35% (ignoring other issues associated with personal ownership).

How to Make the Most of a Bad Situation

Canadian Implications - Individual Shareholder

And When Property is Sold?

- Half of gain is FAPI
- Deduction from FAPI for U.S. taxes paid (reasonably applicable tax up to Canadian taxes otherwise payable)
- Distribution of after-tax proceeds as dividend subject to withholding tax of 15%
- All of distribution is treated as ordinary income (including 50% gain not included in FAPI).

How to Make the Most of a Bad Situation

Canadian Implications - Individual Shareholder

On Distribution of Capital Gains

- Additional Canadian personal tax (Ontario rate) is ≈ 28%
- Total tax (FAPI and Dividend) is ≈ 72.10%
- British Columbia (47.70%) – 68.62%
- Alberta (48%) – 68.80%
- Quebec (53.31%) – 71.99%
- Manitoba (50.40%) – 70.24%
- See notes page for calculation.

How to Make the Most of a Bad Situation

Canadian Implications - Corporate Shareholder

Rental Income – FAPI

- U.S. tax on rental income is till the same.
- Canadian FAPI legislation still applies.
- Deduction for FAPI calculation is different because Relevant Tax Factor is not 2.2 but 4.0, so deduction reduces FAPI inclusion to NIL in corporation.
- No additional Canadian tax and so deferral until paid to individual.

How to Make the Most of a Bad Situation

Canadian Implications - Corporate Shareholder

Dividend Distribution of Rental Income

- No additional tax on distribution of dividends to Canco because of paragraph 113(1)(b) and (c) deductions, see notes page.
- Dividend from Canco is eligible dividend.
- Total tax is 64% under this scenario in Ontario.
- Better than individual shareholder, transfer USCo shares into Canco using section 85? FIRPTA?

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<u>Canadian Implications - Corporate Shareholder</u>

Disposition

- FAPI – same as for individual shareholder
- U.S. tax 40%
- Canadian FAPI – 50% of gain, FTC for U.S. taxes paid, deduction for foreign taxes multiplied by RTF of 4.0 and so no additional income subject to Canadian tax in Canco.
- On distribution, ultimately to individual shareholder, additional Canadian tax payable is $22.80 on $100 of gain, so effective rate is 62.8%. Compare to about 27% on capital gains in Canada, bad. Compare to individual shareholder scenario of 72%, better.

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Canadian Implications - Corporate Shareholder

What if USCo do not pay a Dividend and Repatriate by Way of Capital gains

- Leave funds in USCo.
- No additional Canadian corporate tax because no taxable FAPI.
- Liquidate USCo when property is sold or redeem U.S. shares.
- Effective rate would be 58%.

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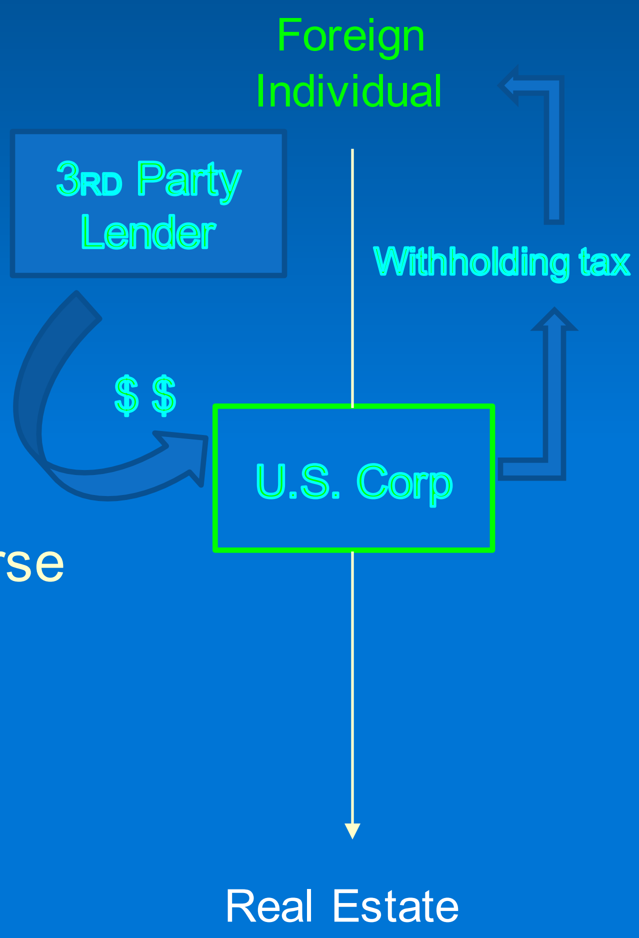
Canadian Implications - Corporate Shareholder

- Not good but better. Most of the tax cost is because U.S. rate of 40%.
- Could reduce U.S. tax by leveraging.
- Need to be mindful of thin capitalization rules and taxable income generated by lender. If interest is received by Canadian resident, still taxed in Canada, but highest rate of 53% is still lower than 58%.

How to Make the Most of a Bad Situation

<u>Anything One Can Do</u>?

- To address U.S. Estate tax exposure:
  - ➢ Reduce value of corporation by putting debt in the corporation
    - ❖ Debt does not have to be non-recourse
    - ❖ Must be third party debt
    - ❖ Must take proceeds out



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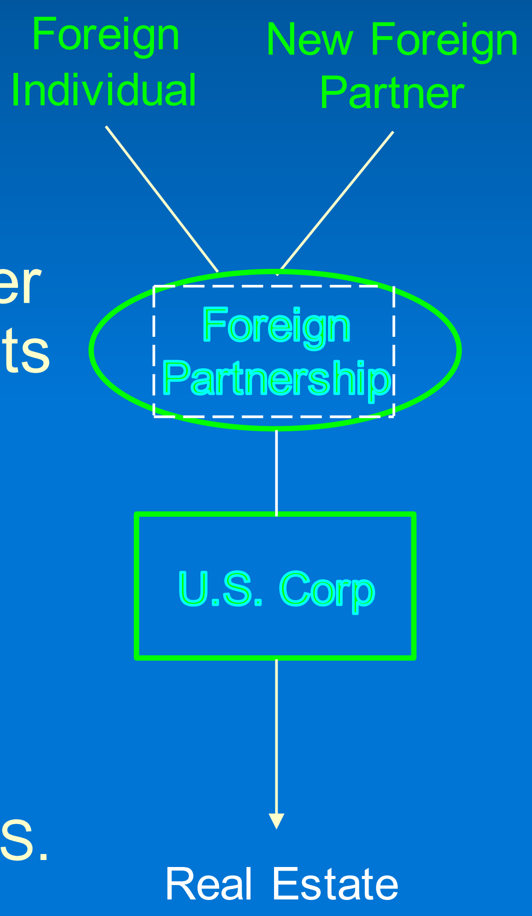
Anything One Can Do?

- To address U.S. Estate tax exposure:
  - Form a foreign partnership with another foreign person who owns foreign assets and check the box to treat as corporation
    - Inversion risk addressed by:
      - Value of “new” property must equals 20% or more of the total partnership’s assets
      - Valid business reason must exist
    - No U.S. tax on transaction if notice to I.R.S. timely made and stock held for 1 year



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<u>Anything One Can Do</u>?

- To eliminate corporate level tax:
  - Gift stock to a U.S. child
    - U.S. Child to make an S election
    - Disposition of real property within the first 5 years will cause gain recognition at corporate level on built in gain at time of election
    - After the gain recognition period, flow through to U.S. child and disposition will be taxed at individual level at preferential rate

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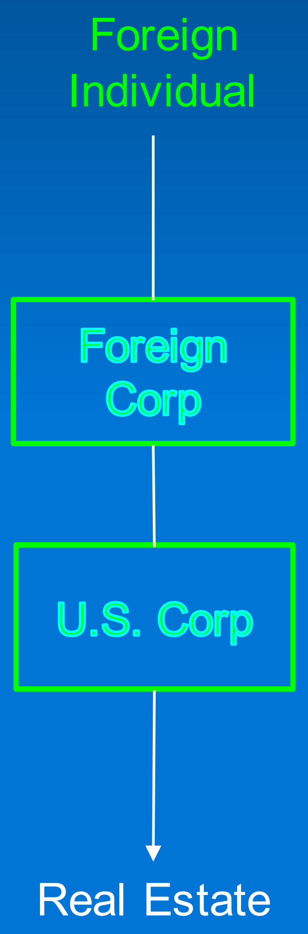
<u>Anything One Can Do</u>?

- If held through Canadian corporation, also consider:
  - Transfer stock of foreign corporation at death to U.S. child
    - Merge Foreign Corp. into U.S. Corp.
    - U.S. Child to elect to treat U.S. Corp as S corporation
    - <u>Query</u>: Canadian tax?
    - If taxable in Canada, is there gain to be recognized?



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Canadian Implications - Other Thoughts

- Avoid FAPI
  - Structure USCo or a related management company to have more than five full-time employees to generate active business income. This may be possible if certain contract positions can be converted to employee positions; or
  - Multiple U.S. corporations may be merged to combine number of employees.

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Canadian Implications - Other Thoughts

- Avoid CFA status – could Canco own less than 50% vote in USCo? No FAPI, income taxable when received, FTC for withholding, no deduction for underlying U.S. tax. May be same as Canco scenario.

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