Canadians Acquiring US Residential Real Property: Cross-Border Considerations

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Abstract

The authors discuss US and Canadian income tax, estate tax, and gift tax ramifications relating to ownership of US real property by Canadians. They also discuss the considerations respecting, and planning issues relevant to, four different types of structures for the ownership of US real property by Canadian residents—ownership by an individual, ownership by a Canadian corporation, ownership by a Canadian-resident trust, and ownership by a Canadian partnership.

Keywords Real property; US-Canada; estate taxes; estate planning; cross-border; individual income taxes.

Introduction

An increasingly common investment for Canadians is residential real estate, primarily vacation properties, in the United States. Ownership of US real estate by Canadians creates numerous tax ramifications. In the United States, two regimes are of primary concern—the income tax regime and the gift and estate tax regime. In Canada, the income tax regime is applicable. Coordination of the two different taxing jurisdictions is vital; the taxpayer and the taxable event must be synchronized in order to minimize the overall tax consequences that may result from such investments.

While the structures that are often considered tend to focus on US issues, it is essential for Canadians to be aware of the Canadian tax issues that arise from the purchase, rental, sale, or deemed disposition of US residential real estate. An approach that integrates the US and Canadian rules in an effective way is important to achieve. Such an approach may result in balancing the advantages and disadvantages of a particular structure; no one structure or approach will work best in all circumstances.

In this paper, we discuss personal-use and rental residential real estate. Commercial real estate issues are beyond the scope of the paper.

The Canadian income tax rules that can have an impact on the ownership of US real estate include

1) the deemed disposition that occurs on the death of a taxpayer owning US real estate;[1]
2) the income attribution rules that apply where a taxpayer other than the taxpayer who actually owns and disposes of a property is required to report the disposition for Canadian income tax purposes;[2]
3) the Canadian benefit inclusion (imputed income) rules;[3] and
4) the deemed disposition by a Canadian-resident trust of all of its capital property on the 21st anniversary date of the creation of the trust.[4]

The US income tax rules relevant to Canadian ownership of US real property include

1) determination of rental income net of deductions for non-resident owners;[5]
2) taxation of gain under the 1980 Foreign Investment in Real Property Tax Act (FIRPTA);[6]
3) withholding taxes with respect to both income categories;[7] and
4) US benefit inclusion (imputed income) rules.[8]

In addition to the coordination of the domestic tax laws of the two jurisdictions, ownership decisions and management practices should take into account the utilization of the Canada-US tax treaty,[9] the coordination of foreign tax credits under Canadian law,[10] the differences in the two jurisdictions' domestic death tax laws, and variable foreign exchange rates.

Overview of the US Transfer Tax System

The US gift and estate tax is an excise tax on gratuitous transfers (property of any kind that is transferred directly or indirectly from one person to, or for the benefit of, another for less than full and adequate consideration) during life or on death.[11] Transfer tax is based on the value of the property transferred. Taxable gifts are those in excess of permitted exclusions, such as the annual exclusion for gifts to any person (US $13,000 per year beginning in 2009), direct payment of tuition or medical expenses, gifts to US-citizen spouses, and gifts to qualified

charities.[12] There is an enhanced annual exclusion for gifts to a non-US-citizen spouse (US $133,000 for 2009).[13]

The US estate tax base (the gross estate) includes the value of all personally owned assets as well as the assets that make up certain trusts (trusts to which the decedent contributed where the decedent retains certain interests,[14] and trusts created by others for the decedent over which the decedent is considered to possess a general power of appointment).[15] Assets that make up the gross estate include the death benefit of insurance on the decedent's life unless the policy is owned in all respects by others. The gross estate is reduced by permitted deductions, yielding the taxable estate. Gift and estate taxes are unified by adding cumulative lifetime taxable gifts to the taxable estate. The sum in excess of the exemption (US $3.5 million in 2009 for US citizens and domiciliaries) is subject to estate tax at the rate of 45 percent.[16]

Permitted deductions include gifts to a US-citizen spouse (including a spousal trust),[17] gifts to qualified charities,[18] liabilities of the decedent that had accrued as of the date of death (including income taxes),[19] and funeral and estate administration expenses.[20] Estate tax credits are also available; the primary estate tax credit is the unified credit, which is the amount of tax that would have been imposed on a taxable estate aggregating US $3.5 million. There are also credits for foreign death taxes, for estate taxes paid with respect to relatively recent inheritances, and for gift taxes paid during life.[21]

As in Canada, estate taxes may be deferred until the death of the second to die of a married couple. If the surviving spouse is not a US citizen, then the deferral is obtained only through the use of a qualified domestic trust (QDOT), the primary features of which are that the surviving spouse is the only beneficiary during his or her lifetime, the surviving spouse receives all of the income of the trust, there is a US trustee, and the trust is subject to a US jurisdiction.[22]

Canadians who are not US citizens will be subject to the US gift and estate tax regimes only with respect to their US-situs assets. US-situs assets for US gift tax purposes include those that are owned individually (or through a lookthrough entity, such as partnerships or certain trusts) and interests in real property and tangible personal property (generally, the contents of real property, but including boats and vehicles) located in the United States.[23] US-situs assets for US estate tax purposes include the categories above, as well as shares of US stocks and debt of US persons or companies.[24] US stocks are those of companies that are organized under the laws of a state; it does not matter where the shares are traded or located. Most publicly traded US bonds are excluded from the debt category.

Unlike a US citizen or resident, however, a Canadian who transfers an asset that is subject to US gift tax (such as an interest in US real property) has no exemption by which to avoid the actual payment of gift tax. Only the annual exclusions identified above are available to reduce gift tax liability.

Considerable relief with respect to US estate tax is accorded to Canadians under the treaty.[25] First, the Canadian estate is entitled to a prorated unified credit against estate taxes (in effect, a share of the US $3.5 million exemption.) The

applicable fraction has a numerator equal to the gross value of the US-situs assets and a denominator equal to the gross value of the decedent's worldwide estate determined as though he or she were a US citizen.

Another important treaty credit is the marital credit, which effectively doubles the prorated unified credit. The marital credit is available when property passes to the non-citizen spouse (who must be of the opposite sex and must have been legally married to the decedent) in a way that would have qualified for the US marital deduction had the surviving spouse been a US citizen (that is, outright or in a spousal trust). However, this credit is available only if the estate forgoes the use of the deduction permitted for property passing to a QDOT. Thus, it is of practical and important use to a Canadian who dies owning US property, who is survived by a qualifying spouse, and whose worldwide estate is between US $3.5 million and US $7 million. For example, if one member of a married Canadian couple acquires US-situs assets worth US $1 million and holds additional assets of US $4 million (determined under US estate tax principles), then, upon her or her death, his or her estate will be subject to US estate tax tentatively computed at US $54,640, taking into account the prorated unified credit of US $291,160.[26] If the decedent was survived by his or her spouse, this tentative estate tax can be deferred by utilizing a QDOT. But the estate tax can be avoided altogether by utilizing the treaty marital credit, which allows the use of as much of the initial prorated unified credit as is needed to minimize the otherwise payable US estate tax. Thus, if the first spouse to die has a worldwide estate of less than twice the amount sheltered by two unified credits (approximately US $7 million), and the surviving spouse receives at least half of the estate from the first spouse to die, the treaty eliminates US estate tax on the US-situs assets.

Another important benefit under the treaty is the mutual foreign death tax credit. In the case of a Canadian who owns US real property, this benefit means that the US estate tax attributable to a US-situs asset on which there is also a Canadian capital gains tax by reason of the deemed disposition at death may offset the Canadian tax.

Applicable US Income Taxes

On Rental Income

Rental income paid by third parties, or rental income that is imputed to the foreign owner through personal use, is US-source income subject to US income tax even if the primary purpose of the property is personal use. Non-residents are subject to withholding tax at a flat rate of 30 percent on the gross rental income (withholding is the responsibility of the tenant unless there is some US intermediary), unless the real property is effectively connected to a US trade or business or the foreign owner elects such treatment.[27] If the rental income is effectively connected to a US trade or business, then deductions are available to reduce the amount of taxable income in the United States, and graduated income tax rates are available with respect to such net rental income. Withholding tax

may be avoided if the payer of the rental payments receives a properly completed form W-8ECI.[28]

Under US tax rules, rental income is not imputed where the personal use is by the individual owners or the beneficiaries of a trust. In the case of a corporate owner, however, the Internal Revenue Service (IRS) has a policy of denying deductions to the corporation and treating the excess of fair rental value over any actual rent as a constructive dividend if the corporation allows its controlling shareholder or his or her family to use the property.[29] However, the IRS will impute rental income to the corporation if a shareholder, officer, or employee of the corporation (or a family member of any such person) uses corporate-owned property without paying fairly for such use.[30] It follows, nonetheless, that if rental income is imputed, then expenses paid by the corporation that would be deductible should be allowable—provided, however, that the corporation files a tax return on a timely basis.

Imputation to partners of a Canadian partnership that owns US real property who are permitted to use such property is unclear. It seems that if the Canadian partnership meets the Canadian enterprise requirements, then the IRS will have a strengthened argument for imputing income.

On Capital Gains

Under FIRPTA, the gain on the sale of US real property is also US-source income and subject to capital gains taxes. Moreover, the buyer must withhold and remit an amount equal to 10 percent of the gross sales proceeds.[31] The foreign owner who is selling may reduce the required withholding based on a calculation of the seller's maximum US income tax liability by obtaining a withholding certificate from the IRS.[32] Note that the proper calculation of the gain requires taking into account permitted adjustments to bases, which include increases due to capital improvements (all determined in US dollars) and subtractions for depreciation (which will be required if the property is effectively connected income).

US income tax rates in 2008 and currently in 2009 vary considerably, depending on the type of entity through which the foreign owner holds title and on the length of time that the property was owned. For example, the maximum federal income tax rate on long-term capital gain property (property that was owned for more than one year) is 15 percent for individuals (including individual partners where the US property is owned by a Canadian partnership) and trusts. The maximum rate applicable to a foreign owner that is a corporation is 35 percent.

Applicable Canadian Income Taxes

A Canadian-resident individual owning real estate in the United States is required to report net rental income from the property on his or her Canadian personal income tax return. Because he or she is also required to report net rental income from the property on a US personal income tax return, and because the United States has the first right to tax such income, Canada grants a foreign tax

credit to the Canadian individual for US taxes owing in calculating the applicable Canadian income taxes.[33]

On the sale of personally owned US real estate, which is generally treated as a capital gain, the taxable portion of the capital gain will be included in income in the year of disposition and will be subject to Canadian income tax at the individual's marginal rate.

Consideration should be given to the potential application of the income attribution rules in the ITA.[34] If all of the funds relating to the purchase of the US real estate are contributed by one spouse and the property is jointly owned by both spouses, the capital gain realized will be taxable in Canada to the spouse who contributed the funds.[35] One-half of the gain will be realized by the contributing spouse as a result of his or her ownership of a one-half interest in the property, and the other one-half of the gain will be attributed to him or her pursuant to the income attribution rules.

One should also determine whether the principal-residence exemption is available and, if so, whether the exemption should be claimed in order to shelter the gain from Canadian income tax.[36] Alternatively, it may be more advantageous to preserve the exemption for application against a gain on the disposition of the individual's main Canadian residence. A significant factor in this decision is the fact that US income tax will still be assessed in respect of any gain realized on the disposition, even though the gain is sheltered in Canada by virtue of the principal-residence exemption. It therefore appears that use of the principal-residence exemption for the US real estate is unlikely to be the most advantageous choice.

In the event that the real estate is sold at a loss, the loss is likely to be denied on the basis that the property was a personal-use property.[37]

A Canadian-resident individual who dies owning US real estate will be considered to have disposed of the real estate immediately before his or her death for proceeds of disposition equal to the fair market value of the property, unless the property is transferred to a spouse, a common-law partner, or a qualifying spousal trust.[38] In these circumstances, a deemed disposition for proceeds equal to the adjusted cost base will apply unless an election is made to not have the transaction take place on a rollover basis.[39]

Consistent with the theme of synchronizing the taxpayer and the taxable event, it is important to note that the use of the spousal rollover in Canada may result in a mismatch of the income tax and the cost base to the extent that US estate tax is payable on the first spouse's death but Canadian income tax is deferred by the use of the spousal rollover.

Structures for the Ownership of US Real Estate by Canadian Residents

In this section of the paper, we consider the following structures for the ownership of US real estate by Canadian residents:

1) ownership by an individual,
2) ownership by a Canadian corporation,
3) ownership by a Canadian-resident trust, and
4) ownership by a Canadian partnership.

Ownership by a Canadian-Resident Individual

Ownership of US real estate directly by a Canadian-resident individual is the simplest structure. The applicable Canadian and US non-resident income tax ramifications where the property is owned by an individual were discussed above. While this approach offers no shelter from US estate tax, it may still be appropriate with respect to US estate tax planning, provided that certain approaches are taken to mitigate exposure to estate tax.

As noted above, if the individual owner is unmarried and his or her worldwide estate is no more than the US estate tax exemption (currently, US $3.5 million), then the estate may elect under the treaty to fully exempt the US real property from estate tax. Similarly, if the individual owner is married and his or her worldwide estate is no more than approximately US $7 million, then two treaty elections will eliminate the US estate tax. Note, however, that in the latter case it is important that the decedent owner's will leave all of his or her US-situs assets (at a minimum) in a testamentary spousal trust for the surviving spouse, the terms of which ensure that the assets of the trust will not be includable in the survivor's estate for estate tax purposes.[40]

Reliance on a similar provision may enable a very wealthy couple to acquire US real property for personal use in individual names, provided that they were willing to restructure the ownership of their assets.

Ownership by a Canadian married couple jointly with right of survivorship can result in US estate taxation on both deaths. This type of ownership is called joint tenancy. On the death of the first spouse to die, 100 percent of the value of the property is considered includable in that spouse's estate for US estate tax purposes unless the executor can prove that the surviving spouse contributed to the purchase of the property. If the worldwide estate of the first spouse to die is greater than US $3.5 million (taking into account the 100 percent includability rule for worldwide assets that are held jointly and other assets that make up one's estate for US estate tax purposes), then estate taxes will be payable on the first death. The surviving spouse will own 100 percent of the property by operation of law if he or she did not sell the property prior to death.[41] If it is desired or required that both spouses own an interest in the property, then they should hold the title as tenants in common, and the will design outlined above should be implemented for both spouses.

The US estate and gift tax regime is a value-based system. Accordingly, US transfer tax valuation principles apply. The key principle is that an interest must be valued on the basis of what a willing third-party purchaser would pay for that interest, irrespective of the actual transferee's relationship to the transferor.[42]

For example, appraisers apply a discount of between 20 and 40 percent with respect to a fractional interest in an asset. Accordingly, acquiring an interest as a tenant in common, even with one's spouse, may lead to a reduction of up to 40 percent in the taxable value.

For Canadian income tax purposes, whether the individual owns an interest in the property with his or her spouse as joint tenants or as tenants in common will make no difference with respect to who is taxable on the gain that is deemed to be realized on the death of the co-owner. A valuation discount may be applicable by virtue of the joint ownership of the property.

Where a Canadian individual does own a direct interest in US real property and there is exposure to US estate tax even after applying the potential treaty benefits, some steps may be taken to reduce the potential US estate tax liability. The primary strategy is for the individual owner (or owners, in the case of a tenancy in common or a partnership) to obtain non-recourse financing. If the US-situs asset is subject to a non-recourse mortgage (or a similar type of collateralization where the US-situs asset is other than real property), the value of the US-situs asset is reduced dollar for dollar by the amount of such financing.[43] Many US financial institutions have entered the non-recourse mortgage market in the last several years. The mortgage would be interest-only in order to maintain the maximum deduction for US estate tax purposes. This interest may be deductible under Canadian income tax rules, provided that the borrowed funds are invested to generate taxable portfolio income.

It also should be noted that when the US estate tax liability cannot be avoided, funding for the liability can be obtained through insurance on the real property owner's life. It may be appropriate for such an insurance policy to be held through a trust that does not constitute part of the owner's worldwide estate for US estate tax purposes in order to avoid reducing the applicable ratio by the death benefit of the insurance policy.

With respect to the Canadian income tax effect on the estate of an individual who dies owning US real property, ignoring a spousal rollover, the individual will be deemed to dispose of the real estate for Canadian income tax purposes based on the value of the US real estate calculated in Canadian dollars. In computing the gain to be reported, the adjusted cost base of the property will be the adjusted cost base at the time of acquisition, again determined in Canadian dollars. It can therefore be seen that foreign exchange fluctuations can also have an impact on the gain that will be realized from the deemed disposition of the real estate. Pursuant to the Canada-US treaty, any US estate tax applicable may be creditable against the Canadian capital gains tax on the deemed disposition at death.[44] So the real test is not to totally avoid US estate tax but to keep it within the projected Canadian capital gains tax if possible.

For US purposes, US estate tax is imposed on the fair market value of a Canadian's US real estate, in addition to other US-situs property. Because US estate tax is imposed at a higher rate than Canadian capital gains tax, and because the US estate tax is assessed on the fair market value of the property rather than on

the accrued capital gain, US estate tax is usually higher than the Canadian income taxes owing as a result of the deemed disposition at fair market value on death.

If the Canadian owner of the US real estate is married, it is important to ensure that his or her will is drafted appropriately in order to allow the deferral of both Canadian and US tax until the death of the surviving spouse and to permit the application of available foreign tax credits. This objective can generally be achieved if a testamentary trust that constitutes a qualifying spousal trust for Canadian tax purposes[45] and a QDOT under US law is created, as discussed above.

In order to obtain the deferral of tax for the transfer of property to a qualifying spousal trust, the trust terms must provide, generally speaking, that all income of the trust be payable to the surviving spouse and that no capital of the trust may be distributed to a beneficiary other than the surviving spouse during the lifetime of the surviving spouse.[46]

If the Canadian owner of US real estate makes a charitable donation in his will, the amount of the donation may be claimed as a credit in computing the Canadian income taxes payable on the terminal return.[47] The individual is also allowed a US estate tax charitable deduction for bequests made to US domestic charities.[48] Employing a charitable donation strategy may therefore reduce or eliminate applicable Canadian income taxes and US estate tax on death of the owner, or on the death of the second to die of an owner and his or her spouse (assuming that the QDOT was utilized to defer the estate tax on the owner's first death).

It seems possible that a donation of a partial undivided interest in the US real property can also be made to a charity. By doing so, one may be able to reduce the US estate tax to a level where it does not exceed the Canadian capital gains tax applicable on the terminal return. Valuation considerations may arise with respect to the value of an undivided interest in the real estate. As well, this strategy seems most appropriate when it is intended that the property is to be sold after the individual's death rather than retained and used by the deceased's children.

Ownership by a Canadian Corporation

In past years, it was relatively common for Canadians to invest in US real estate through a Canadian holding corporation, often established as a single-purpose corporation, in order to avoid direct ownership of US-situs assets. The reasoning was that what the individual owned at the time of death was simply shares in a foreign corporation, clearly not a US-situs asset. (A US corporation would be ineffective for avoiding US estate tax because the shares in a US corporation would be US-situs assets for estate tax purposes.)

In such cases, the US estate tax issue is whether a lookthrough rule may be applied. It is one author's experience that while the IRS has long maintained that it routinely and successfully ignores such foreign holding corporations, particularly single-purpose corporations and other holding corporations that are wholly

owned by the deceased, the IRS's success seems to be merely anecdotal. Moreover, research indicates that there are no cases or rulings directly supporting the IRS's position, even in analogous circumstances, except where the corporate formalities have not been followed or the corporation was found to be purely a nominee title holder.

From a Canadian perspective, a Canadian corporation, if properly structured, was considered to eliminate US estate tax on death, and the shareholders were able to avoid shareholder benefit issues for Canadian income tax purposes. A corporation of this type was referred to as a single-purpose corporation.

While section 15 would ordinarily include in the income of a shareholder the value of any benefit conferred on the shareholder, and the personal use of corporate assets would be a shareholder benefit, the Canada Revenue Agency (CRA) had a longstanding administrative position whereby the taxable benefit was not imputed in circumstances where a single-purpose corporation that met certain criteria was the owner of the US real estate.[49]

According to the CRA, a corporation had to meet seven conditions to be considered a single-purpose corporation for the individual who provided the funds or the real estate to the corporation.

> 1) The corporation must be a Canadian corporation. . . .
> 2) The corporation's only objective is the holding of a residential real property in the United States for the individual's use or enjoyment. The corporation cannot hold any other property, and it cannot hold more than one property at a time.
> 3) The individual and/or related individuals are the only shareholders of the corporation.
> 4) The only transactions of the corporation relate to its objective of holding property in the United States for the individual's personal use or enjoyment.
> 5) The shareholder must pay all the operating expenses of the property personally, with the result that the corporation will show no profit or loss with respect to the property on any of its income tax returns.
> 6) The corporation acquired the property with funds provided solely by the shareholder. This condition will be satisfied if the funds are received from the shareholder personally.
> 7) The property must be acquired by the corporation on a fully taxable basis. Therefore, the property cannot be transferred to the corporation on a tax-deferred [rollover] basis under section 85 of the Income Tax Act.[50]

Notwithstanding that the ownership of the US real estate by a corporation may effectively address US estate tax and avoid shareholder benefit issues from a Canadian income tax perspective, this approach has certain significant disadvantages in comparison with personal ownership. Of particular significance is that US corporate income tax rates are now generally much higher than US individual income tax rates, particularly with respect to capital gains that are realized. Corporations have no special capital gains tax rate, so a substantial

portion of any capital gain realized on the sale of the property by the corporation would be taxed at a 35 percent US federal income tax rate. Further, tax and legal compliance costs are much higher for a corporation than for individual owners of real estate.

As a result of the changes made to the treaty in 1995, which permitted a Canadian foreign tax credit relating to US estate tax owing against the Canadian income tax owing as a result of the deemed disposition on death of US real property, the CRA decided to review its administrative position with respect to the non-application of the shareholder benefit rules relating to single-purpose corporations that own US real property. The outcome of this review was the announcement by the CRA on June 23, 2004[51] that it would withdraw its administrative policy and take the position that a taxable benefit should be assessed in relation to a shareholder's personal use of real estate owned by a single-purpose corporation effective January 1, 2005. From and after that date, the historical administrative policy no longer applies with respect to any new property acquired by a single-purpose corporation or a person who acquires shares of a single-purpose corporation, unless the share acquisition is the result of the death of the individual's spouse or common-law partner. In these circumstances, a spouse or a spousal trust can receive the shares in a grandfathered single-purpose corporation without losing the effect of the applicable grandfathered protection.[52]

According to the CRA, the taxable benefit for single-purpose corporations that are not covered by the past administrative policy is required to be calculated in accordance with the position set out in *Interpretation Bulletin* IT-432R2.[53] If the real estate owned by the corporation is available for the personal use of a shareholder, a shareholder benefit will be considered to be conferred on the shareholder whether or not the shareholder contributed to the cost of the US property or paid any operating expenses related to the property. The calculation of the taxable benefit is normally based on one of two approaches—the fair market value rent approach or the imputed rent approach.[54]

Under the fair market value rent approach, the shareholder benefit is equal to the fair market value rent for the property less the consideration (rent) paid to the corporation by the shareholder for the use of the property.

If the fair market value rent is not considered to be an accurate measure or cannot be readily determined, the shareholder benefit is based on the imputed rent approach. In this situation, a shareholder benefit is calculated as follows:

1) Determine the net amount by which the greater of the cost or the fair market value of the property exceeds any interest free loans or advances made to the corporation by the shareholder to acquire the property.
2) Multiply the net amount by a normal rate of return, usually the prescribed rate of interest for purposes of the Act to determine an initial benefit amount.
3) To this initial benefit amount, add the operating cost paid by the corporation to arrive at an imputed rent.

4) The shareholder benefit is equal to the imputed rent less any consideration (rent) paid to the corporation by the shareholder for the use of the property.

The imputed rent calculation may be appropriate in circumstances such as a luxury property.

Given the CRA's revocation of its former administrative policy (that there was no shareholder benefit relating to ownership of US real estate by a single-purpose corporation) and other disadvantages of corporate ownership of property, the acquisition of a US property by a corporation after 2004 does not seem generally advisable.

Where a US property was acquired by a single-purpose corporation prior to 2004, continued ownership by the corporation may be appropriate in most circumstances. The Canadian tax ramifications of unwinding the corporate ownership include (1) income tax at the corporate level based on the accrued gain that is realized by the corporation when the property is transferred to the individual, and (2) income tax at the individual level arising from a taxable dividend resulting from the transfer of the property by the corporation to the individual. A gain will also be recognized for US purposes under FIRPTA, although the US tax should be available as a tax credit to the Canadian corporation. However, the immediate tax cost and the other costs of unwinding the structure should be compared with the higher future income tax that will be incurred by the corporation if the structure is left in place.

Continued ownership by the corporation may not be appropriate when there has been little appreciation in value of the property to date; in such a case, it may be possible to transfer the property from the corporation on a basis that results in an acceptable level of tax.

Corporate ownership may be appropriate when the funds to acquire the US real property are currently held by a corporation and the property will be a rental property rather than a personal-use property. If the real property is owned by the corporation, the personal tax that would be paid on a distribution of funds to the shareholder to permit personal ownership may be avoided. Further, one might consider having the Canadian corporation invest the funds in a US corporation, which would then acquire the property: ownership by a US corporation may simplify US withholding tax issues.

If the single-purpose corporation ownership structure is in place when the shareholder dies, then, subject to spousal rollover provisions, a fair market value disposition of the shares in the corporation is deemed to occur immediately before the death of the shareholder, triggering Canadian income tax.

As a result of the deemed disposition, the estate or the beneficiaries of the deceased will end up with shares in the Canadian corporation that have an adjusted cost base calculated on the current fair market value of the underlying US real estate owned by the corporation. While it may be possible to bump up the cost of the underlying real estate for Canadian income tax purposes by using a pipeline

strategy[55] or to mitigate double tax considerations from a Canadian perspective by using an ITA subsection 164(6) strategy, these approaches may be effective only in a Canadian context and not for US tax purposes. A transfer of the property utilizing tax-planning strategies in Canada will result in a disposition of the property by the single-purpose corporation, and US capital gains tax will be incurred. If the subsection 164(6) strategy is employed and the US real estate is transferred by the Canadian corporation as proceeds of disposition on a repurchase of shares, the single-purpose corporation may be able to claim a Canadian tax credit in respect of the US income tax applicable on the transfer of the property. If the pipeline strategy is used, US taxes may result even where no Canadian taxes are payable.

Ownership through a single-purpose corporation makes the deceased shareholder's interest vulnerable to attack by the IRS: the US real property may be includable in the decedent's estate for US estate tax purposes under IRC section 2036 or 2038 (the retained interest rules). Although there are no published rulings or case law on the matter, examiners for the IRS anecdotally claim that single-purpose corporations are analogous to nominee corporations under Canadian income tax rules. The retained interest rules are not limited to beneficial interests in trusts, and are theoretically applicable to transfers to business entities over which the decedent retains both a beneficial interest and control. As long as the Canadian corporation is not a sham, however, the exception for "full and adequate consideration" should protect the decedent's estate from the application of those rules. (In exchange for the contribution of the cash used to purchase the property, the shareholder received stock in the corporation of equivalent value.) Note that the IRS should not be able to apply this lookthrough analysis differently for income tax and estate tax purposes. If the single-purpose corporation sells the property, the IRS will expect any gain to be reported on a non-resident corporate return, and the gain will be subject to the higher rate of income taxation.

Ownership by a Canadian-Resident Trust

In many circumstances, ownership of US real estate by a Canadian discretionary inter vivos trust can be an effective way of structuring the ownership of US real property. Such a structure should avoid US estate tax, and it may also minimize the Canadian taxation of accrued capital gains that would otherwise result from the deemed disposition of property owned by a Canadian-resident individual.

In order to effectively avoid exposure to US estate tax on the death of a family member, the trust must be established by the person supplying the cash to make the purchase. That person cannot retain any beneficial interest in the trust, nor can she or he be permitted to control the trust (in short, the person cannot be either a beneficiary or the trustee). In addition, the steps set out below should be followed.

1) Any contract to buy real property should be executed by the trustee of the trust. Thus, the trust's effective date of creation should precede any such

action. If a beneficiary is the sole trustee, then it is prudent to have the other adult beneficiaries consent to the purchase.

2) US and Canadian lawyers should review the draft trust agreement before it is executed to ensure that it complies with Canadian trust law and US tax law, and the Canadian and US tax consequences should be explained fully (whether or not the property is to be rented to third parties).
3) If US real property is acquired or a US bank or investment account opened (or if the trust is a US-resident trust), the trust must obtain an IRS EIN (employer identification number).
4) The trustee of the trust should open and maintain a US-dollar bank account for the trust (perhaps interest-free in order to avoid having to file Canadian tax returns).
5) The settlor must transfer the necessary funds to the trust's bank account (or perhaps to the real estate lawyers or title company on behalf of the trustee if the bank account is properly documented as a trust account) to permit the trust to make its desired investment.
6) For the purposes of any real estate deed and any other documentation related to the ownership of real property, title to the property must be taken in the name of the trust. Similarly, insurance, etc., should be obtained in the name of the trust. (Additional considerations apply if there is to be financing for the purchase of any real property or improvements thereto.)
7) If real property is held in the trust for use of the beneficiaries, then the trustee may ask the beneficiaries to pay some or all of the annual expenses, including real estate taxes and maintenance; if they do, such payments should be made directly by the beneficiaries. On the other hand, if the trust has sufficient cash, it may pay such expenses. The trust must, however, be solely responsible for capital improvements, which may require the settlor to make an additional contribution or the trustee to borrow funds. No beneficiary may contribute to the trust during his or her lifetime. The settlor and beneficiary spouse may add assets to the trust upon death, either as a bequest under wills or by beneficiary designation.

From a Canadian perspective, it is important to avoid the reversionary trust rule in ITA subsection 75(2). If the reversionary trust rule is applicable, then, on an actual disposition of the property by the trust, the gain will be taxable in the United States to the trust but attributed to the settlor in Canada.[56] A clear mismatching of the reporting of the gain triggers double taxation, because no effective use of foreign tax credits in Canada is available.

Because a transfer of real property to an irrevocable trust is a completed gift for US gift tax purposes, it is imperative that the trust be funded with cash first and that the trustee actually purchase the property. Some practitioners will utilize a trust vehicle even after a Canadian owns US real property. Under this approach, a trust is settled as described above with cash, and the trustee then enters into a purchase contract under which the US real property is acquired for fair market

value from the owner. A capital gain is reported for both US and Canadian purposes, and the property arguably is then sheltered from estate tax for reasons set out above. Neither of the authors uses this approach, however, because economically (but for the income tax event) the owner-settlor ends up with the same amount of cash and the US real property has been transferred from him or her to the trust. It follows that the appropriate analysis is that the Canadian owner has made a transfer to the trust that is subject to US gift tax.

From a Canadian income tax perspective, the CRA has an administrative practice that permits the use of the trust-owned property by beneficiaries of the trust without a taxable benefit being received by the beneficiaries.[57] Notwithstanding this position, in the CRA's view a taxable benefit, pursuant to ITA subsection 105(2), is conferred on a beneficiary in the event that the trust maintains and otherwise pays for the upkeep of the trust-owned property. The US income tax rule with respect to the use of trust-owned property by a beneficiary is the same; personal use of property held in a trust does not cause income to be imputed to the trust, nor is it treated as a distribution to the beneficiaries.[58]

If the beneficiary spouse dies before the non-beneficiary spouse, the non-beneficiary spouse must pay rent to the trust for the continued use of the property. If children of the Canadian-resident parents are included as beneficiaries of the trust, the trust can be effectively used to pass US real estate on to the next generation.

On an actual disposition of the property by the trust, it is advisable that the gain arising from the sale not be allocated or made payable to the Canadian beneficiaries of the trust in order to avoid a mismatching of the taxpayer that reports the gain in Canada and the taxpayer that reports the gain in the United States. Instead, the trust reports the gain arising from the disposition of the property in the United States and also reports the gain in Canada, claiming a foreign tax credit (to the extent that it is available) on the Canadian income tax return in respect of the US income tax payable by the trust.

The trust may be entitled to designate the US real property that has been sold as a principal residence for Canadian income tax purposes. ITA section 54 permits a personal trust to claim the principal-residence exemption and thereby reduce or eliminate a capital gain that the trust would otherwise have on the disposition of the property. In order to qualify for the principal-residence exemption, the property must be ordinarily inhabited in the year by a specified beneficiary or the spouse, common-law partner, former spouse, former common-law partner, or child of the specified beneficiary.

If the principal-residence designation is made by the trust, no other property may have been designated as a principal residence by any specified beneficiary of the trust for the particular taxation year or by any person who is a spouse, common-law partner, child (other than a married child, a child in a common-law relationship, or a child over 18 years of age) of the specified beneficiary. As a result, the claiming of the principal-residence exemption by the trust may have an adverse impact on the beneficiary's ability to claim the principal-residence

exemption in respect of a property owned directly by the beneficiary. As well, for the trust to be entitled to claim the principal-residence exemption, a corporation (other than a registered charity) cannot be a beneficiary of the trust.

The advantage of the trust's claiming the principal-residence exemption (if available) is that the income taxes payable by the trust are thereby limited to the US capital gains rate, which is generally lower than the Canadian capital gains rate. Therefore, the excess Canadian tax will be eliminated by the principal-residence exemption.

Caution should be used, however; this planning approach can affect the ability of beneficiaries to claim the principal-residence exemption in respect of their own property and may therefore result in a reduction of the overall number of principal-residence exemptions that can be claimed in total among the beneficiaries.[59]

In the event that the real estate is sold for a loss, the loss is likely to be denied on the basis that the property was a personal-use property.

Assuming that the reversionary trust rule has never been applicable to the trust, it is possible to wind up the trust in the future and distribute the trust property, including the US real estate, on a tax-deferred basis for Canadian income tax purposes to the capital beneficiaries of the trust, provided that the beneficiaries are, at that time, Canadian residents.[60]

Assuming that the real property is not a personal-use property, any capital losses realized by the trust on a disposition of the US real estate as noted above can only be used to offset capital gains realized by the trust in the year of the loss, the three prior taxation years, and any succeeding taxation year and may not be allocated to the beneficiaries of the trust.[61] If the US real estate is personal-use property, any capital loss realized on a disposition of the property will be deemed to be nil.[62]

The use of the trust may be an effective estate-planning approach for the beneficiaries in that a beneficiary's interest in a discretionary trust is generally thought to have a nominal value.[63] Therefore, if the spouse beneficiary dies leaving children as beneficiaries, he or she will be considered to have disposed of property—namely, his or her interest in the discretionary trust—with only a nominal value, thereby incurring little or no Canadian income tax relating to a deemed disposition of the property.

As noted above, one disadvantage of the Canadian-resident trust is that it may, for practical purposes, have a 21-year planning horizon. Under ITA subsection 104(4), a Canadian-resident trust is considered, for Canadian income tax purposes, to dispose of all of its capital property on the 21st anniversary of the date on which the trust was created. It may therefore be advisable to transfer the property out of the trust and avoid the deemed disposition that would otherwise occur on the 21st anniversary. Both Canada and the United States may provide a rollover of the property out of the trust.[64] Once the property has been removed from the trust, however, the individual beneficiaries, who have become owners of US real property, will thereafter be exposed to estate tax in the United States. The income taxes payable by the trust on the deemed disposition should

be compared with the estate taxes payable if the property is transferred to the beneficiaries.

When deciding whether to transfer the property out of the trust in order to avoid the 21-year deemed disposition, one should consider whether the property will be sold in any event. It is important to avoid a situation where a deemed disposition of the property occurs for Canadian income tax purposes and there is no disposition for US purposes, because a mismatching of foreign tax credits will occur. If the property will be sold to a third party in the near future, consideration may be given to having the trust sell the asset to a corporation owned by one or more beneficiaries of the trust and then reacquire the property from the corporation shortly thereafter. The trust should be able to claim a foreign tax credit in Canada for the US taxes paid, and the cost base of the property for both Canadian and US purposes will be increased. This approach should address the potential estate issues in the United States and permit a proper matching of the Canadian foreign tax credits for the US taxes paid.

One significant practical disadvantage of the trust structure is that the individual who is interested in acquiring the US real estate must actually be prepared to relinquish both ownership and control of the real estate to the trust. The taxpayer is really only able to use the property as the spouse of a beneficiary of the trust and on a rental basis after the death of the spouse beneficiary.

Ownership by a Canadian Partnership

The most complicated approach to owning US real property is to hold it through a Canadian partnership. A partnership exists when there is a relationship where partners carry on a business in common with a view to profit.[65] If the sole activity of the partnership is the ownership of a personal-use real property in the United States, however, a partnership may not exist.

The concept of carrying on a business for the purposes of determining whether a partnership exists should be something less than the concept of carrying on a business for income tax purposes. It is possible that a partnership which, in addition to owning the US real estate, owns an investment portfolio would be viewed as carrying on business to an extent sufficient to permit a partnership to exist. Clearly, if a partnership does not exist, any planning opportunities offered by a partnership will not be available.

In a general partnership, all of the partners are responsible for all liabilities of the partnership; alternatively, the partnership may be established as a limited partnership.[66]

If the partnership is a limited partnership, a corporation should be the general partner and the Canadian-resident individuals should be limited partners in the partnership. The general partner has full responsibility for all liabilities of the partnership. A US corporation may be an appropriate general partner, since the partnership property is located in the United States. Because a corporation's interest in the profits as a general partner is normally a nominal amount, little

future capital gain will be taxed at the corporate tax rate. However, the shares in the corporation will still be US-situs assets.

It is generally accepted that the Canadian and US federal tax regimes apply equally to US and foreign partnerships that hold US real property, assuming that the partnership does not elect to be treated as a corporation for US tax purposes. Therefore, the partner reports his or her share of partnership income, including any rental income and any realized capital gains on the sale of the US real property interests by the partnership.[67] An individual Canadian partner reports the partnership income on his or her personal income tax return and pays the applicable Canadian income tax thereon, subject to the claiming of a credit for any US income taxes owing. The Canadian-resident partner also reports his or her share of the partnership income on a US personal income tax return.

For Canadian tax purposes, a sale of the US real property triggers a capital gain, which flows through and is taxable to the partners. One-half of the total capital gain is included in each partner's income proportionate to the partnership interest.[68] An individual partner pays individual income tax on the partnership income allocated to him or her, subject to the claiming of a foreign tax credit for US taxes payable. A corporate partner, such as a general partner in a limited partnership, pays corporate tax on the partnership income allocated to it, again subject to the claiming of a foreign tax credit for any US income tax payable.

The income flowed through to each of the partners increases the adjusted cost base for income tax purposes of their interest in the partnership.[69] A subsequent cash distribution by a partnership is treated as a reduction of the increased adjusted cost base and therefore should be a tax-free distribution to each of the partners.[70]

A gain realized on the sale of the US property is also subject to US taxation. Unless the US check-the-box election to treat the Canadian partnership as a corporation has been made, the partnership will be treated as a flowthrough entity for US tax purposes.[71] Each of the partners is subject to US tax on their share of any partnership income, including capital gains realized by the partnership. The Canadian individual partners pay US tax at individual tax rates. The United States provides for a favourable federal capital gains tax rate for individuals. Any corporate partner, including a general partner of a partnership, pays tax at the applicable corporate income tax rate on any partnership income allocated to it.

As with sales of US real property by other foreign ownership structures, withholding at the rate of 10 percent of the amount realized (the gain under US tax principles) is required under FIRPTA on the sale (or on any deemed sale) of US real property by a Canadian partnership.[72] Typically, withholding is made with respect to the partnership itself, and the partners file their respective non-resident income tax returns, reporting their allocable shares of US gain and the withheld taxes. The Canadian partnership files a non-resident return as well, but because it is not the taxpaying entity, the return is for information purposes.

US-source income is allocated to the Canadian partners of the Canadian partnership; therefore, it will be necessary to comply with the US withholding tax rules. As noted above, US rental income may or may not be considered effectively

connected with a US trade or business, and the withholding rules differ accordingly. The Canadian partnership itself is a "non-withholding foreign partnership" if it provides a form W-8ECI to the tenant.[73] The FIRPTA withholding tax rules also apply with respect to the sale by the partnership of the US real property. Obtaining the proper withholding certificates is more problematic in light of the flowthrough to multiple partners, particularly if one or more of the partners are non-US corporations.

Both Canadian and US income tax will be payable in respect of the sale of the US real estate. To eliminate this double tax, the partners can reduce their Canadian tax by claiming a foreign tax credit, subject to certain limitations. The foreign tax credit is limited to the amount of Canadian tax that would otherwise be payable on the partnership income allocated to the Canadian partner, including the capital gain on the sale of the US real property.[74] As a result, the foreign tax credit in Canada may be limited to an amount that is less than the full amount of US federal and state tax paid.

Because a Canadian partnership is a flowthrough entity for all US tax purposes, on the death of an individual Canadian partner, his or her proportionate share of the underlying US real property will be considered a US-situs asset for estate tax purposes.[75] Valuation discounts may be available to reduce the value of the US real property includable in the deceased partner's estate, but US estate tax may be payable. The deferral of such estate tax through the use of the marital deduction rules described previously may be difficult if the partnership restricts the transfer of interests on the death of a partner.

One method of avoiding the estate tax applying to a deceased partner's interest in a Canadian partnership that holds US property (or other US-situs assets) is to elect under the check-the-box rules to have the partnership treated as a corporation for all US tax purposes.[76] Because a Canadian partnership is making the election, after the effective date of the election for all US tax purposes, including the US estate tax, the partnership is considered to be a Canadian corporation. Consequently, the interest of any partner is sheltered from US estate tax in the event of the partner's death. Of course, such an election makes the gain from any sale of the US real property subject to the higher US corporate income tax rates. That income tax, however, should be available to the Canadian partners as a foreign tax credit to be applied against any gain that they report for Canadian purposes.

It also should be noted that the check-the-box election results in the Canadian partnership being treated as having contributed all of its assets and liabilities to a foreign corporation in exchange for stock, followed by the liquidation of the partnership.[77] Thus, the election will trigger a deemed disposition for US income tax purposes. As a result, if the election is made after the partnership has acquired the US real property, a sales event must be reported for US income tax purposes, and FIRPTA withholding will be required. This may also lead to a mismatch of Canadian income taxation, particularly with respect to a subsequent sale of the property by the partnership.

If a partnership structure is used, decisions must be made with respect to who the partners should be. The intended beneficial owners of the US real estate should clearly be partners. If the beneficial owners are a married couple and one of the spouses has a significantly greater estate tax exposure than the other, consideration may given to making only the spouse with the smaller estate tax exposure a partner.

One advantage of having a Canadian corporation as the general partner is that all of the partners are Canadians and the partnership qualifies as a "Canadian partnership" under the Act. This characterization permits a rollover of property for Canadian tax purposes from a partner to the partnership. Generally, under US partnership tax law, contributions of real property by partners to a partnership are also tax-free events.[78] One disadvantage to the use of a Canadian corporation is that the Canadian corporation is subject to US branch tax with respect to its partnership interest. If the only asset is personal-use, however, it is likely that the income that is subject to the tax will be minor.

As noted above, shareholder benefit issues exist with respect to the ownership of US real property by a Canadian corporation. In contrast, use of the US real property by a partner does not result in a taxable benefit for Canadian income tax purposes. It is unclear under US partnership tax law whether any income would be imputed to partners, particularly if the partnership has not elected to treat any income as effectively connected income.

On the death of an individual partner, he or she will be considered to have disposed of his or her partnership interest for proceeds of disposition equal to the fair market value of the partnership interest immediately before the death of the partner, subject to the availability of a spousal rollover.[79] As a result, the estate or the beneficiaries of the individual partner will receive the partnership interest at a bumped-up adjusted cost base. An outstanding issue is whether the deceased is eligible to claim a foreign tax credit in his or her terminal return for any US income tax that is payable as a result of the check-the-box election made in the United States.

The use of a partnership approach raises many more planning issues concerning the unwinding of the structure after the death of the individual partner than is the case with individual ownership or ownership by a trust:

- If the US check-the-box election is made, the partnership will be treated as a corporation in the United States and as a partnership in Canada, resulting in a possible mismatching of tax systems.
- There is no 21-year rule applicable to partnerships; therefore, a partnership structure may be appropriate if the individual is expected to live for more than 21 years after acquisition of the US property or if he or she wishes to provide for longer-term ownership than is feasible under a trust.
- A trust does not have an annual tax return filing requirement in the United States if its only activity is the holding of US real property that is used by the beneficiaries personally. If a partnership has the necessary activity to constitute a business for the purpose of establishment of the partnership,

there will likely be a filing requirement for the partnership in both Canada and the United States.
- The partnership structure presents considerable uncertainty with respect to some aspects of the structure. Practitioners also differ on whether the IRS will accept a post-mortem check-the-box election as valid for US estate tax purposes or whether the election will result in a deemed transfer of property that may be subject to IRC section 2035.

In view of the uncertainty about the use of the partnership structure and the complexities involved with this arrangement, a partnership structure may be most appropriate in circumstances where individual ownership or ownership by a trust is not considered to be a viable alternative.

Selection of an Ownership Structure: Summary

Many factors should be taken into account in arriving at the most appropriate structure to be utilized for a particular Canadian who is considering the purchase of US real estate. There is no one right approach that works best in all circumstances. Considerations will involve the applicable Canadian income taxes and US income taxes, gift taxes, and estate taxes. Tax considerations include

- the value of the US property and the value of the worldwide estate of the Canadian resident,
- the resulting US estate tax,
- the resulting Canadian and US income tax consequences on an actual sale of the property, and
- the resulting Canadian income tax consequences on the death of the owner.

Some non-tax considerations with respect to the selection of alternative ownership structures include

- the complexity of administration of the structure (this may be particularly important for taxpayers who do not deal effectively with complex structures);
- any business purpose of the structure, particularly if the establishment of a partnership is a requirement;
- the costs of implementing and maintaining the structure;
- the availability and effectiveness of less complex approaches to mitigate US estate tax, such as personal ownership coupled with life insurance, non-recourse financing, and possible charitable donation planning;
- the liquidity of the estate and the ability to pay any US estate tax that may be applicable;
- the intentions of the individual regarding the property, such as how long he or she wishes to own the property and whether the property is to be maintained as a family asset after his or her death;

- the age, health, and insurability of the individual, particularly where life insurance funding is being considered; and
- the marital status and stability of family relationships (particularly when a trust is being used, because the taxpayer is essentially giving the property away in that planning approach).

Conclusion

This paper has discussed many of the Canadian and US tax issues that should be considered when determining the most appropriate structure for the purchase and ownership of US real property. In order to reduce the overall income tax burden, coordination of the two different taxing jurisdictions is vital. Planning should be done to synchronize the taxpayer and the taxable event in order to minimize the overall tax consequences that may result from the ownership of US real property by a Canadian.

While minimization of the income tax results is important, non-tax considerations may also be relevant with respect to the selection of the most appropriate ownership structure. In the end, there is no one approach that necessarily works best in all circumstances; the choice of an ownership structure to hold US real property will depend on the particular individual's circumstances and objectives.

Notes

1 Subsection 70(5) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "ITA").

2 ITA sections 74 and 75.

3 ITA subsection 15(1) and section 246.

4 ITA subsection 104(4).

5 Section 482 of the Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

6 The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), subtitle C of the Omnibus Budget Reconciliation Act of 1980, Pub. L. no. 96-499, enacted on December 5, 1980, added IRC sections 897 and 6039C. IRC section 897(a)(1) generally treats a gain or loss from the disposition by a non-resident alien individual or foreign corporation of a US real property interest as a gain or loss that is effectively connected with the conduct of a trade or business in the United States, thereby making it subject to US income taxation. IRC section 1445 sets out the withholding tax requirements.

7 IRC sections 1441 to 1446.

8 For a discussion and analysis of this topic, see David G. Roberts, "Structuring Ownership by Canadians of US Real Property: A Review of Current Issues and Planning," in *2005 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2005), tab 10, at 5.

9 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on 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 (herein referred to as "the treaty").

10 ITA section 126.

11 IRC section 2501, et seq. (gift taxes); IRC section 2001 et seq. (US domestic estate taxes); and IRC section 2101 et seq. (non-resident US estate taxes).

12 IRC sections 2503(b) (non-spouse annual exclusion) and (e) (educational and medical expense exclusion); and IRC section 2523 (deductible gifts to US-citizen spouses).

13 IRC section 2523(i).

14 IRC sections 2036, 2037, and 2038.

15 IRC section 2041. The general power of appointment is essentially the ability to appoint trust assets to or for the benefit of oneself, one's estate, one's creditors, or the creditors of one's estate.

16 IRC section 2001(c) provides the tax rates, and IRC section 2010 sets forth the exemption amount (which actually translates to a tax credit, referred to as the unified credit).

17 IRC section 2056.

18 IRC section 2055.

19 IRC section 2053.

20 Ibid.

21 IRC sections 2014, 2013, and 2012, respectively.

22 IRC section 2056A and the Treasury regulations issued thereunder. The requirement is imposed under IRC section 2056(d).

23 IRC section 2501(a)(2).

24 IRC section 2101 et seq. IRC sections 2104 and 2105, and the regulations thereunder, delineate US-situs assets and the exceptions thereto.

25 Article XXIX B of the treaty, added by the third protocol (1995), provides the benefits described in this and following paragraphs.

26 Calculated as $1,000,000 divided by $5,000,000, multiplied by $1,455,800, which is the tax that would be imposed on a $3,500,000 estate (the unified credit amount available to a US citizen's estate).

27 IRC section 871(c).

28 IRS form W-8ECI, "Certificate of Foreign Person's Claim that Income Is Effectively Connected with the Conduct of a Trade or Business in the United States."

29 See, for example, *Transport Mfg. & Equipment Co. of Del. v. Com.*, 70-2 USTC 9604 (8th Cir. 1970); aff'g. TC Memo 1968-190.

30 IRC section 482.

31 IRC section 1445(a).

32 Ibid.

33 ITA section 126.

34 ITA sections 74.1, 74.2, 74.3, and subsection 75(2).

35 ITA section 74.1.

36 ITA paragraph 40(2)(b).

37 ITA subparagraph 40(2)(g)(iii).

38 ITA subsection 70(6).

39 ITA subsection 70(6.2).

40 For example, if the surviving spouse were to be a trustee of such spousal trust, by limiting capital encroachments to so-called "ascertainable standards" (such as for the spouse's health, support in reasonable comfort, or maintenance), the exclusion would be available.

41 Under applicable regulations, a post-death QDOT may be established and funded by the surviving spouse within the time for filing the US estate tax return, thereby enabling the deferral. Whether a Canadian rollover is available in such circumstances is uncertain because the surviving spouse will be transferring an appreciated asset (in most cases) to a trust that may not be eligible under the alter ego trust rules.

42 A full discussion of US valuation rules is far beyond the scope of this paper. The seminal statement of the principles is found in Rev. rul. 59-60, 1959-1 CB 237. See also the regulations under IRC section 2031.

43 Treas. reg. section 20.2053-7. A normal mortgage, where the deceased non-resident alien borrower is also liable in the event of a default, only gives rise to a prorated deduction, and therefore is far less beneficial than a liability that may reduce the value of the US-situs asset on a dollar-for-dollar basis.

44 Article XXIX B of the treaty.

45 ITA section 108 and subsection 70(6).

46 ITA subsection 70(6).

47 ITA subsection 118.1(1).

48 IRC section 2106(a)(2). The fifth protocol to the treaty (2007) eliminated the ability to obtain a full US estate tax deduction for US-situs assets that passed to a Canadian charity by reason of one's death.

49 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 20, at 606-7.

50 Nadja Ibrahim, Paul Ideias, and Beth Webel, "Ownership of US Residential Property by Canadian Residents," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 7:1-27, at 7:12.

51 *Income Tax Technical News* no. 31, June 23, 2004.

52 Ibid., at 2.

53 *Interpretation Bulletin* IT-432R2, "Benefits Conferred on Shareholders," February 10, 1995.

54 Ibid., at paragraph 11.

55 The pipeline strategy attempts to avoid the impact of double taxation on an estate where the deceased owns shares in a corporation, and those shares are left to certain beneficiaries. The deceased is deemed to have disposed of the shares at fair market value immediately prior to death and therefore is taxed on the accrued capital gain. Tax consequences are also triggered by an eventual sale of the corporation's assets, or by the beneficiary's distribution of the corporation's assets to himself or herself. For a discussion of the pipeline strategy, see Tim Cestnick, " 'Pipeline Strategy' Helps Eliminate Double Taxation Problem," *Globe Advisor*, July 31, 2008 (online: http://www.globeadvisor.com/servlet/ArticleNews/story/gam/20080731/RCESTNICK31).

56 ITA subsection 75(2). In the United States, provided that the property was held for at least one year, the rate of tax applicable will be 15 percent as per IRC sections 1222 and 1.

57 *Income Tax Technical News* no. 11, September 30, 1997.

58 *Henry Bradley Plant*, 30 BTA 133 (1934); aff'd. 76 F. 2d 8 (2d Cir. 1935); and *Alfred I. Dupont Testamentary Trust*, 66 TC 761 (1976); aff'd. 574 F. 2d 1332 (5th Cir. 1978).

59 For a further discussion of considerations with respect to ownership of a principal residence by a trust, see Maria Elena Hoffstein, "Tax Planning with Trusts—Current Issues," in *2007 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2007), tab 13.

60 ITA subsection 107(2).

61 *Interpretation Bulletin* IT-381R3, "Trusts—Capital Gains and Losses and the Flow-Through of Taxable Capital Gains to Beneficiaries," February 14, 1997; and ITA section 111.

62 ITA subparagraph 40(2)(g)(iii) and sections 46 and 54.

63 While a discussion of the valuation of an interest in a discretionary trust is beyond the scope of this paper, some jurisprudence (principally in the matrimonial-law context) has caused uncertainty with respect to the generally held view that an interest in a discretionary trust has a nominal value. In certain circumstances, the CRA may challenge a nil value position. For further discussion and consideration of this topic, see Jason M. Stephan, "Understanding and Dealing with the 21-Year Deemed Disposition Rules Affecting Certain Trusts," in *2008 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2008), tab 14, at notes 9 and 10.

64 IRC section 643(e), under which the termination of a trust and distribution to beneficiaries does not trigger gain recognition unless there is an affirmative election to do so.

65 *Interpretation Bulletin* IT-90, "What Is a Partnership?" February 9, 1973.

66 The applicable legislation in Alberta is the Partnership Act, RSA 2000, c. P-3, as amended.

67 IRC section 701.

68 ITA sections 96 and 38.

69 ITA generally at subdivision J and section 96.

70 Ibid.

71 See infra note 76.

72 IRC section 1445(a).

73 Supra note 28, and Treas. reg. section 1.1441-5(c)(1)(ii)(B).

74 *Interpretation Bulletin* IT-270R3, "Foreign Tax Credit," November 25, 2004.

75 This is not to say there is not substantial state law under which an interest in a partnership that continues after a partner's death is considered intangible property. Bear in mind that a partnership interest is not included in the definition of US-situs assets. Therefore, in order to have exposure to US estate and gift tax, the lookthrough rules must apply. The rulings that do exist in this area are at least 50 years old. But those rules indicate that if a partnership's primary assets are interests in US real property, then a proportionate amount of those interests will be included in the Canadian individual partner's estate.

76 In 1996, final regulations were issued as Treas. reg. sections 301.7701-1, 301.7701-2, and 301.7701-3. These regulations eliminated, for qualifying business entities, application of the classification criteria for corporations, partnerships, and other business entities previously in use. The regulations, known as the check-the-box rules, permit an eligible business entity that has at least two members to elect classification as an association (taxable as a corporation) or classification as a partnership. A qualifying entity that has only one member may elect between tax treatment as a corporation and tax treatment as a sole proprietorship. Thus, a Canadian partnership may elect to be treated as a Canadian corporation for all US tax purposes. Such an election is made on IRS form 8832, "Entity Classification Election," and may be made at any time after the entity is formed. The election may be made effective at any time 75 days before and 12 months after the date of filing.

77 Treas. reg. section 301.7701-3(g)(1).

78 IRC section 721.

79 ITA subsections 70(5) and 96(1.5).