Canadian Ownership of U.S. Real Property

The increase in value of the Canadian dollar, along with the depressed housing prices south of the border, has led to more Canadians considering the purchase of a U.S. vacation property.

While the confluence of circumstances is making it attractive for Canadians to enter the U.S. real estate market, it is important for those who are considering a purchase of U.S. residential property to fully understand the U.S. reporting and tax issues related to their ownership of U.S. real property, in addition to any Canadian tax implications.

This article briefly outlines the Canadian and U.S. income and estate tax implications for a Canadian resident (who is not a U.S. citizen or Green Card holder) who purchases U.S. real property as a vacation property, and includes a summary of potential ownership structures when considering a U.S. real property purchase. A discussion of strategies related to the ownership of U.S. real property for the purposes of generating rental income is beyond the scope of this article, however some U.S. income tax considerations with respect to earning rental income and the sale of the property are provided at the end of the article.

U.S. Estate Tax

Unless the vacation property is transferred to a surviving spouse (or qualifying spousal trust) at the time of death, a Canadian would generally incur Canadian income tax on the unrealized capital gains on the property as a result of a deemed disposition at fair market value of the property at death. Note that this gain would be calculated in Canadian dollars such that the actual capital gain or loss reported would include a foreign exchange component in addition to any change in the U.S. dollar value of the property.

For U.S. tax purposes, the Canadian owner of U.S. real property may also be subject to U.S. estate tax on that property if the individual has U.S. situs assets in excess of US$60,000 and the value of their worldwide assets are in excess of the exclusion amount in the year of their death. In 2011, the exclusion amount is US$5 million. U.S. situs assets include such things as real property located in the U.S. and stocks, options and mutual fund units issued by a U.S. entity. Instead of imposing tax on the unrealized gain, the U.S. will impose U.S. estate tax on the fair market value of the property at the time of death. However, there is some relief provided in the Canada/U.S. Income Tax Treaty which allows a deduction against Canadian federal income tax for U.S. estate tax payable on property that is located in the U.S. This deduction

can significantly reduce the Canadian income tax applicable to that property.

For more information on U.S. estate tax for Canadians, please ask your BMO Nesbitt Burns Investment Advisor for a copy of our concept sheet *U.S. Estate Tax For Canadians*.

Structuring the Ownership of U.S. Real Estate by Canadian Residents

In order to address a potential U.S. estate tax liability, there are several ownership structures that a Canadian may consider for a U.S. residential property including:

1) Direct ownership
2) Ownership through a Canadian-resident trust
3) Ownership through a Canadian partnership
4) Ownership through a Canadian corporation

1) Direct Ownership

Individual ownership

Ownership of a property by an individual allows for limited U.S. estate tax planning opportunities. U.S. estate tax may be reduced or eliminated by maximizing the credits and deductions available to that individual. If the individual is married, it may be beneficial to have the spouse with the lower net worth assume ownership of the property, particularly if the spouse has worldwide assets less than the applicable U.S. estate tax exemption amount ($5 million for 2011 and 2012). However, if any property is transferred between spouses, it will be important to consider the attribution rules that may be applicable for Canadian income tax purposes on any annual income or capital gain from the eventual sale of the property, which could impact the effectiveness of this strategy.

If the U.S. estate tax liability cannot be fully eliminated, life insurance could be considered as a means of funding the residual U.S. estate tax liability.

Joint tenancy with the right of survivorship

Ownership by a married couple jointly with right of survivorship is the simplest structure for the transfer of assets at death and is often used for probate tax planning. However, this ownership structure is generally not recommended for Canadian couples who own U.S. real estate as there is the potential that the full value of the U.S. property would be subject to U.S. estate tax twice: once when the first spouse dies and again when the second spouse dies.

A married couple who own a property jointly with the right of survivorship may want to consider severing their joint tenancy and create a tenancy in common based on the original contributions of each spouse. If the new ownership structure is not reflective of each spouse's contribution, then U.S. gift tax may be triggered. As previously mentioned, the Canadian attribution rules should also be considered upon any transfers between spouses.

Tenancy in common

As noted above, if each spouse wishes to own an interest in the property, a more favourable structure may be to own the property through a tenancy in common.

Under a tenancy in common, each spouse may have equal or unequal shares of the interest in the property. In this structure, the deceased's share of the property passes to whoever is designated under the Will and not automatically to the surviving spouse. This strategy allows more flexibility for planning opportunities as each spouse may direct that his or her share of the property pass to a spousal trust.

For example, each spouse can create a testamentary trust for each other so that the portion of the property that was owned by the first spouse to die is excluded from the estate of the surviving spouse. This can reduce or eliminate the U.S. estate tax on the death of the surviving spouse

by reducing the value of the U.S. situs property and worldwide estate on the second death.

Another planning technique is to include a provision in the Will such that the property is transferred from the estate to a Qualifying Domestic Trust ("QDOT"). This could defer both the U.S. estate tax and Canadian income tax until the death of the surviving spouse. The QDOT does not eliminate the U.S. estate tax, it simply defers the timing of the estate tax. The deferral would allow for the U.S. estate tax to be applicable at the same time as the Canadian income tax upon death of the surviving spouse, thereby allowing for the application of available foreign tax credits to reduce the Canadian tax from the deemed disposition at death.

2) Ownership by a Canadian Resident Trust

Ownership of U.S. real estate by a properly structured Canadian discretionary inter-vivos trust provides another alternative. U.S. estate tax could be avoided since at death, the property is owned by a trust (and not the individual) which is not subject to U.S. estate tax. In order to avoid exposure to U.S. estate tax, the trust should purchase the property using funds provided by the individual who establishes the trust. Since the transfer of real property to an irrevocable trust would be considered to be a gift for U.S. gift tax purposes, it is important that the funds be transferred into the trust first before the property is purchased.

One disadvantage for the Canadian trust ownership structure is that for Canadian income tax purposes, a Canadian resident trust is deemed to have disposed of all its capital property on the 21st anniversary of its creation date. As such, the structure only generally allows for a 21-year planning opportunity. It is also important to draft the terms of the trust agreement such that the gain on an eventual sale of the property is not attributed back to the settlor for Canadian income tax purposes to ensure the proper application of foreign tax credits to avoid double taxation.

Another drawback to consider is that an individual who acquires U.S. real estate using a trust should be prepared to give up both ownership and control of the real estate to the trust. The person funding the trust cannot be a beneficiary or the trustee of the trust. The individual who settled the trust would only be able to use the property as the spouse of a beneficiary of the trust or on a rental basis after the death of the spouse beneficiary.

3) Ownership through a Canadian Partnership

It may be possible for U.S. estate tax to be minimized if U.S. real property is held by a Canadian partnership which makes an election to be treated as a corporation in the U.S. for U.S. tax purposes.

However, it should be noted that ownership of a U.S. real property through a Canadian partnership is one of the most complicated alternatives to hold property and involves some uncertainty around the tax implications as the IRS has not provided any definitive guidance on the tax implications for this particular structure.

4) Ownership through a Canadian Corporation

In the past, the use of a single purpose Canadian holding company to purchase U.S. real estate was a popular planning technique. This was due to a former CRA administrative policy that stated that shareholders of single purpose Canadian holding companies holding U.S. real property would not be assessed taxable benefits in Canada for their rent-free personal use of the real estate owned by their corporations. However, in 2005, the CRA changed its administrative policy, and began to assess such shareholders for the taxable benefits arising from their personal use of the real property held by their corporations. As a result of this change in policy, the use of a single purpose Canadian holding company to purchase a U.S. vacation property is no longer a very attractive ownership strategy to minimize U.S. estate tax exposure.

Another disadvantage of holding U.S. real estate through a corporation is that the applicable rate for U.S. income tax purposes on any capital gain realized on the sale of the property may be much higher for a corporation that that of a trust or an individual. For these reasons this structure is generally not recommended any longer. However, previous structures established prior to the CRA changes may be grandfathered.

Non-Recourse Mortgage

Another alternative that may be considered is to obtain a non-recourse mortgage on your U.S. real property. This type of mortgage reduces the value of U.S. situs property on a dollar for dollar basis. The borrower under a non-recourse mortgage, has no personal liability and the lender can only look to the real property to enforce payment. This type of funding may be difficult to obtain from a commercial lender.

Other U.S. Income Tax Considerations

Property Rental

If you decide to rent out your U.S. real property, there are additional complexities. For example, a tenant who pays rent to a Canadian owner of a U.S. property is required to withhold a 30% withholding tax on gross rents unless the property owner elects to treat the rent as "effectively connected income". An election to treat the income as effectively connected income may allow for the following:

1. No withholding would be required if a Form W-8-ECI is provided to the individual who is paying the rent.
2. The Canadian property owner may be able to claim certain deductions such as depreciation, maintenance costs and property taxes. Some restrictions may apply if the property is used for personal purposes in addition to generating rental income.
3. The net rental income would be subject to graduated individual income tax rates.
4. A U.S. individual income tax return (Form 1040NR) would need to be filed by the owner to report the rental income or loss.

For Canadian income tax purposes, the rental income should also be reported. However, a foreign tax credit may be claimed for the U.S. income tax paid on the rental income to offset some of the Canadian income tax on the same income. In addition, there may be a requirement to include a Foreign Income Verification Statement (T1135) with your Canadian income tax return.

Sale of U.S. real property

Withholding tax

Upon the ultimate sale of your U.S. real estate property, there are several important U.S. and Canadian tax implications. Under the Foreign Investment in Real Property Tax Act ("FIRPTA"), an individual who buys U.S. real estate from a seller who is not a U.S. citizen or resident is generally required to withhold 10% of the purchase price and remit that amount to the IRS as an instalment towards the seller's ultimate U.S. tax liability on the sale.

In order to decrease or eliminate the withholding amount, a Canadian seller may obtain an IRS withholding certificate, ideally before the transfer of property. A seller that has applied for a withholding certificate must notify the buyer in writing that the certificate has been applied for on the day of or prior to the transfer of property. The IRS will normally act on an application for a withholding certificate within 90 days of receipt of all information necessary to make a proper determination. If a certificate is issued before the transfer of property, the withholding amount may be decreased or eliminated. Any withholding tax on the certificate would be based on the amount of U.S. income tax that would actually arise from the gain on the sale of the property rather than simply 10% of sales

proceeds. If a withholding certificate is issued after the transfer of property, the IRS may authorize an early refund of any excess withholding tax.

The gain or loss on the sale of U.S. real property by a non-U.S. person is required to be reported on a U.S. individual non-resident income tax return. A State income tax return may also be required, depending on the State's income tax regime. When the individual files the tax return, they must pay additional tax if the withholding did not sufficiently cover the taxes, or claim a refund if the withholding tax was in excess of the actual U.S. tax liability. Therefore, Canadians who own U.S. real property should maintain complete records of the property purchase and any capital improvements so that the U.S. tax cost can easily be determined at the time of sale.

In addition to the U.S. reporting requirements, a Canadian who sells U.S. real property must report the gain for Canadian income tax purposes. As with the case of U.S. taxes paid on rental income, any U.S. income tax paid on the gain from the sale of the property may be claimed as a foreign tax credit to offset Canadian income tax payable on the gain from the sale. The gain for Canadian income tax purposes would be calculated in Canadian dollars such that the actual capital gain or loss reported would include a foreign exchange component in addition to any change in the U.S. dollar value of the property.

Conclusion

While this article places more emphasis on the U.S. income and estate tax considerations of owning a U.S. vacation property, Canadian residents should weigh the results from any planning for U.S. income and estate tax against the impact on their Canadian income tax. Ultimately, the most appropriate planning strategy that minimizes their overall tax liability which encompasses both jurisdictions should be determined.

In addition to tax considerations, legal and other considerations such as the administrative complexity and burden of maintaining a certain structure, the costs (such as professional fees) for implementing and maintaining a structure and the intentions of the individual with respect to the property should be evaluated before making a final decision on a tax strategy. Finally, given the complexity and the need to coordinate the tax implications in both jurisdictions, it is very important that individuals seek the advice of a cross-border estate tax professional before the purchase of a U.S. property to ensure the proper analysis and implementation of any tax planning strategy.

Please contact your BMO Nesbitt Burns Investment Advisor for assistance in finding a cross-border estate tax professional.

The comments included in the publication are not intended to be a definitive analysis of tax law: The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

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