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Tax Notes

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Kill Bill: Is C-10 on the Ropes?

One year ago, direct from a Maui windsurfing beach, I wrote an open letter in this newsletter to Finance Minister Flaherty inviting him to come to the beach for a chat. And, what more appropriate topic of conversation can there be than international tax, particularly the foreign investment entity ("FIE") and non-resident trust proposals then in Bill C-33 – now Bill C-10 ?[1]

While the article was entitled "Mr. Flaherty, Tear Down These Rules", I ended, rather modestly, requesting that he might "make some changes to these proposals".[2] I cited as an example, the plight of a beneficiary of a non-resident estate (or trust), who could have to pay tax based on an interest factor applied to the estate's entire asset base, even though he or she may receive only pennies from the estate and, as a second example, I cited a FIE proposal requiring a person who comes to Canada with a foreign life insurance policy to revalue the policy each year and pay tax on its increase. (Doesn't everyone have the information and expertise to do this?)

As most readers are aware, Bill C-10 has been in legislative limbo for many months. Having passed through the House of Commons, the Bill found its way to the Standing Senate Committee on Banking, Trade and Commerce and has been there for all of 2008, with no signs of passage in sight. This level of review from a body that has traditionally rubber-stamped legislation is likely unprecedented.[3]

Fatal Detraction?

In the meantime, some other extraordinary events have taken place. First, when the Committee commenced its hearings in December 2007, STEP representative Robin McKnight criticized the proposals as "unduly complicated and ... fatally flawed". Then there was an impromptu groundswell of e-mails in January 2008. Starting with a few practitioners complaining about the international component of Bill C-10, the distribution list got longer and longer, swelling to 200 or so participants, consisting of many, if not most, of the leading Canadian practitioners in international personal tax planning.

The culmination of this process was a letter to Senator David Angus, the Chairman of the Standing Committee[4] – endorsed by dozens of leading tax advisors – criticizing the non-resident trust and FIE proposals as "fundamentally unsound" and "virtually impossible to comprehend", and asking that these proposals be stripped from Bill C-10 for further consideration.

Since that time, to a large extent, the torch has been carried by three tax lawyers from Davies Ward Phillips & Vineberg ("DWPN"). In late January, Nat Boidman wrote about the non-resident trust and FIE proposals in an op-ed piece appearing in the *National Post*,[5] labelling them "unnecessary, unworkable and excessive". On May 1st, Michael Kandev wrote a similar piece[6] adding a third troublesome area, the restrictive covenant proposals, citing their complexity, inappropriate broad scope, and punitive effect. The article stated that the outcry from practitioners "received only a luke warm reaction from officials at the Department", and that pleas for revisions were ignored.

A month later, another senior tax partner from DWPV, Steve Ruby,[7] was called to testify before the Standing Committee. Mr. Ruby called for the Senate to kill the non-resident trust, FIE, and restrictive covenant proposals.[8] Describing them as "fundamentally flawed", Mr. Ruby testified that they "can only be fixed by reformulating the conceptual approach to the concerns raised in these areas". While Mr. Ruby did not purport to speak for his partners, a day later at the annual STEP conference in Toronto, Nat Boidman endorsed Mr. Ruby's testimony, and cited a "disconnect" between what Finance says it is doing in press releases on the subject and what it is actually doing in the legislation. To literally adhere to the rules, Mr. Boidman observed, "the FIE proposals can require a small investor in a Fortune 500 company, to hire a forest of advisors"[9] in order to show that the investment is not caught by the rules.[10]

As a result of these efforts, where we stand now – a year after my Maui article – is that there is a real possibility that wholesale changes to Bill C-10 may occur. The Committee has indicated that it will not pass the tax content of the Bill as is, and has asked the Department of Finance and tax practitioners' representatives to work something out.

Drop 'em a Line

So guess where I am? But this time, I am not writing to Mr. Flaherty. I am asking you to write.

I want you to tell Mr. Flaherty that the non-resident trust, FIE, and restrictive covenant proposals are seriously flawed and should be scrapped. Tell him that you agree with Michael Kandev that the controversy surrounding Bill C-10 has also exposed some fundamental issues with the process of making Canadian tax laws. Tell him that the Department of Finance Tax Policy Branch should be reorganized to ensure that Canadians are taxed pursuant to clear, fair and well designed tax laws.

If you join in this effort, there is a real possibility that the problematic provisions in Bill C-10 could be substantially changed or even killed. Mr. Flaherty's e-mail is: jflaherty@fin.gc.ca.[11] Senator Angus can be copied at his e-mail: anguswd@sen.parl.gc.ca .[12]

If this effort meets with success, we will be particularly indebted to the three DWPV tax practitioners who have showed that their principles are more important to them than a cushy relationship with Finance.

– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide. Special thanks to Nathan Boidman.

TAX NOTES

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Notes:

[1] In case you didn't read the article, the analogy is that Canadians are outnumbered both as windsurfers and businesspeople. In the latter case, we don't need complex and punitive international tax rules holding us back.

[2] *Tax Notes*, No. 535, August 2007.

[3] Although much of the fuss has been over "Censorgate" in respect of film funding, rather than arcane tax proposals.

[4] Addressed to Senator W. David Angus, Chairman of the Sanding Committee, by Paul LeBreux, January 28, 2008.

[5] "Offshore excess; Bill C-10 will hit onshore investments, as well as offshore", January 29, 2008.

[6] Also in the *National Post*, "Wake-up to Tax Laws", May 1, 2008.

[7] Testimony before the Standing Senate Committee on Banking, Trade and Commerce, June 4th.

[8] In a letter to the Finance Minister dated March 8 , 2007, The Tax Executives Institute made the same recommendation.

[9] Canadian and U.S. tax lawyers, securities lawyers, tax accountants, forensic accountants, business valuators, stock brokerage advisors, and psychiatrists – due to tests relating to the investor's motive for acquiring the investment.

[10] Testimony before the Standing Senate Committee on Banking, Trade and Commerce, June 4th.

[11] Mr. Flaherty's mailing address is:
The Honourable James M. Flaherty
Minister of Finance
Department of Finance Canada
140 O'Connor Street
Ottawa, ON K1A 0G5

[12] Senator Angus's mailing address is:
The Honourable W. David Angus, Q.C.
903 Victoria Building
The Senate of Canada
Ottawa, ON, Canada
K1A 0A4

The Purchase of U.S. Vacation Property by Canadians – A Complicated House Deal

The combination of the recent subprime mortgage crisis, the general downturn in the U.S. economy, a strong Canadian economy, and the Canadian dollar hovering on par with the U.S. dollar have resulted in many Canadians seeking to capitalize on the opportunity to purchase U.S. vacation property. Western Canadians are seeking out vacation properties in Arizona, California and Nevada, while eastern Canadians are looking to Florida and the Carolinas for that piece of paradise in the sun.

Tax practitioners have been attempting to develop the optimal structure for a Canadian to hold a U.S. vacation property; however, as will become clear below, there is no perfect tax plan and the most beneficial structure will depend on the circumstances in terms of balancing the pros and cons of each available structure. The analysis becomes more complex if the U.S. vacation property is a joint investment to be owned by two or more Canadian residents, such as a co-ownership arrangement among a number of individuals, married couples, or common-law couples.

Canadian and U.S. Tax Systems

From a tax perspective, a person will fall under the purview of the Canadian tax system and the provisions of the *Income Tax Act* (Canada) (the "ITA") if that person is resident in Canada.[1] In that situation, the person is subject to tax payable to the Canadian government on all sources of that person's worldwide income, subject to a credit for foreign taxes paid to a foreign government on non-business income[2] and any relief provided in an applicable tax treaty between Canada and that foreign country. The applicable tax treaty is the Canada–United States Tax Convention (the "Canada–U.S. Tax Treaty"). For U.S. tax purposes, a person will be defined as a "nonresident alien" pursuant to the *Internal Revenue Code* (United States) (the "Code") if that person is not either a citizen or a resident of the United States.[3] It is a Canadian resident's status as a nonresident alien of the United States that makes him or her liable for tax payable to the U.S. government under the U.S. tax system for limited purposes (such as income earned from U.S. situs property, gift tax, and estate tax, all of which are discussed below). For the purposes of this article, it will be assumed that the Canadian resident who owns U.S. vacation property satisfies the definition of nonresident alien in the Code. From the perspective of the U.S. tax system, the Canada–U.S. Tax Treaty would also apply to determine the ultimate tax liability of the Canadian resident owing to Canada and the United States, respectively. Prior to any adjustments made with respect to foreign tax credits or the application of relieving provisions contained in the Canada–U.S. Tax Treaty, the holding and disposition of U.S. vacation property by a Canadian resident will have the following income tax implications.

Canada

For Canadian tax purposes, the holding of U.S. vacation property by a Canadian resident will be treated in exactly the same fashion, from a tax perspective, as if it were located in Canada. If the U.S. vacation property is solely for personal use, then there are no income tax implications associated with using the property.[4] Any rental income earned would be subject to tax and if the property is sold for a profit, the difference between the proceeds of the sale and the amount originally paid for the property will be taxed as a capital gain in the year of disposition.[5] If the U.S. vacation property is held by a Canadian resident individual at death, the property will be deemed to have been disposed of at its fair market value at the time of death and the deceased's estate would be liable to pay the tax on any accrued capital gain.[6] In terms of reporting requirements, the Canadian resident would include any tax reporting with respect to the U.S. vacation property as part of his or her Canadian tax return.

United States

For U.S. tax purposes, the Canadian resident is taxed as a nonresident alien as defined in the Code. If the U.S. vacation property is solely for personal use, then there are no income tax implications associated with using the property and, more importantly, there is no requirement to file a U.S. tax return with the Internal Revenue Service (the "IRS"). However, if a nonresident alien earns any rental income from the U.S. vacation property, not only does this trigger the requirement that the nonresident alien file a U.S. tax return with the IRS,[7] but this would also impose an obligation on the person paying the rent in the United States to withhold 30% of the gross amount to be paid as rent and to remit this directly to the IRS on behalf of the nonresident alien.[8] The IRS compliance requirements and associated costs may be enough of a disincentive to cause the Cana-

dian resident to choose not to rent out the U.S. vacation property. If the U.S. property is owned by multiple owners, each owner will need to comply with the IRS filing requirements.

With respect to dispositions of the U.S. vacation property during the Canadian resident's lifetime, U.S. federal and state taxes will be payable on any capital gain,[9] and depending on the state where the property is located, there may be a 10% withholding tax that the purchaser must deduct from the purchase price and remit to the IRS. The Canadian resident will be required to file a U.S. tax return for the year in which the property was disposed of.

Of more significance from a U.S. tax perspective is if a nonresident alien (the Canadian resident) dies while still owning the U.S. vacation property. The United States does not have a "death tax" similar to Canada (where there is a deemed disposition of all property of the deceased at its fair market value and any accrued capital gains are taxed in the estate); rather, the United States has the concept of "estate tax", which is a direct tax, at a very high rate, based on the fair market value of the property at death.[10] The mechanics of the estate tax are an important factor in deciding how the Canadian resident should hold title to the property. As an example, if a Canadian couple who are common-law partners (not legally married) purchase a U.S. vacation property and register themselves on title as joint tenants, the entire fair market value of the property may be subject to estate tax upon the death of the first person, and then, upon the death of the remaining person, the entire fair market value of the property may be subject to estate tax again, in both cases with limited tax credits available. Some planning techniques are outlined below that can reduce or at least defer a portion of the estate tax liability.

Gift tax

Another U.S. concept that is foreign to the Canadian tax system is the U.S. gift tax. A full analysis of the gift tax is beyond the scope of this article, but for purposes of the estate tax, gift tax in the United States will be triggered (at a similar rate as estate tax and payable by the donor of the gift) if prior to death, the Canadian resident transfers the U.S. vacation property to someone else for less than its fair market value.[11] Therefore, estate tax cannot be avoided by transferring the U.S. vacation property for nominal consideration prior to death – the estate tax will simply be replaced by the gift tax. The United States also imposes "generation-skipping transfer tax", which is an additional tax (computed at the same rates as estate tax and payable by the donor) where a transfer is made to a person who is two or more generations below the donor (such as a grandparent transferring property to a grandchild). For both the gift tax and the generation-skipping transfer tax there are lifetime exemptions available to U.S. citizens/residents.[12]

Calculation of Estate Tax and Treaty Relief for Nonresident Aliens

The section above on the Canadian and U.S. tax systems outlines a number of taxation results associated with a Canadian resident (or nonresident alien for U.S. tax purposes) purchasing a U.S. vacation property and then renting it, selling it, or dying in possession of it. For the most part, the taxes on the capital gains in respect of the disposition of the property by an individual during the person's life are palatable.[13] However, the U.S. estate tax liability upon the death of the Canadian resident can be debilitating to an estate and can be duplicated unintentionally and unnecessarily; therefore, tax planning to reduce or defer the estate tax is a valuable exercise.

U.S. estate tax[14]

U.S. estate tax can be described as a politically charged sliding scale tax, the magnitude of which for a Canadian resident (or nonresident alien for U.S. tax purposes) will depend on the following variables: the individual's marital status,[15] worldwide wealth at death (and, most importantly, the proportion of the individual's wealth that is represented by U.S. situs assets), and the particular year in which the individual dies.[16]

The process of determining the estate tax liability associated with a U.S. vacation property[17] starts with determining the total gross estate tax liability applicable to the fair market value of the U.S. vacation property held on death.[18] The next step is to ascertain the credit that is available in that year which, subject to the final step, may be deducted from the gross estate tax calculated in step one (this is referred to as the "Unified Credit" and outlined in the Table).[19]

Table – Estate Tax Calculations – Marginal Estate Tax Rates and Available Unified Credit

<table>
<tr><th></th><th>(US$)</th><th>2008</th><th>2009</th><th>2010</th><th>2011</th></tr>
<tr><td rowspan="18">Threshold</td><td>$0</td><td colspan="2">18%</td><td rowspan="18">Estate tax repealed</td><td>18%</td></tr>
<tr><td>$10,000</td><td colspan="2">20%</td><td>20%</td></tr>
<tr><td>$20,000</td><td colspan="2">22%</td><td>22%</td></tr>
<tr><td>$40,000</td><td colspan="2">24%</td><td>24%</td></tr>
<tr><td>$60,000</td><td colspan="2">26%</td><td>26%</td></tr>
<tr><td>$80,000</td><td colspan="2">28%</td><td>28%</td></tr>
<tr><td>$100,000</td><td colspan="2">30%</td><td>30%</td></tr>
<tr><td>$150,000</td><td colspan="2">32%</td><td>32%</td></tr>
<tr><td>$250,000</td><td colspan="2">34%</td><td>34%</td></tr>
<tr><td>$500,000</td><td colspan="2">37%</td><td>37%</td></tr>
<tr><td>$750,000</td><td colspan="2">39%</td><td>39%</td></tr>
<tr><td>$1,000,000</td><td colspan="2">41%</td><td>41%</td></tr>
<tr><td>$1,250,000</td><td colspan="2">43%</td><td>43%</td></tr>
<tr><td>$1,500,000</td><td colspan="2" rowspan="5">45% on every $1 over $1,500,000</td><td>45%</td></tr>
<tr><td>$2,000,000</td><td>49%</td></tr>
<tr><td>$2,500,000</td><td>53%</td></tr>
<tr><td>$3,000,000</td><td rowspan="2">55% on every $1 over $3,500,000</td></tr>
<tr><td>$3,500,000</td></tr>
<tr><td rowspan="2"></td><td rowspan="2">Unified credit available</td><td>2008</td><td>2009</td><td>2010</td><td>2011</td></tr>
<tr><td>$780,800</td><td>$1,455,800</td><td>$0</td><td>$345,800</td></tr>
</table>

The first two steps of determining the gross estate tax calculation and the Unified Credit that is available are determinations made pursuant to the Code that are the same calculations made for the determination of estate tax liability of a U.S. citizen or U.S. resident. However, as provided for in the Canada–U.S. Tax Treaty, a Canadian resident (a nonresident alien for US tax purposes) is only entitled to deduct from his or her gross estate tax calculated *a portion* of the gross Unified Credit that is otherwise available to U.S. citizens/residents (the "Proportional Unified Credit") based upon the following formula:[20]

$$\frac{\text{gross fair market value of U.S. situs property}}{\text{gross fair market value of worldwide estate}} \times \text{total Unified Credit available} = \text{Proportional Unified Credit}$$

Therefore, the final step is the determination of the Proportional Unified Credit which is then deducted from the gross estate tax (as calculated) in order to determine the exact estate tax liability of the estate.[21] As is evident by the calculation of the Proportional Unified Credit, it is very difficult to ascertain at the outset what worldwide estate value threshold for a Canadian resident must be reached before estate tax is triggered, since that determination is completely dependent on first determining the ratio of the value of U.S. situs assets to the value of worldwide assets for any particular deceased individual.[22] It follows that if the U.S. vacation property owned by the Canadian resident represents only a small percentage of a large worldwide estate, the Proportional Unified Credit will be of minimal assistance in materially reducing the estate tax liability.

Marital credit and credit for estate tax paid by transferor

An additional relieving provision is contained in paragraph 3 of Article XXIX-B of the Canada–U.S. Tax Treaty, which provides that if the U.S. vacation property is transferred by way of a will to the surviving spouse of the deceased, then the deceased's estate may claim an additional "marital credit" that is calculated in the same fashion as the Proportional Unified Credit calculated above.[23] If this provision is satisfied, the deceased's estate will be able to deduct twice the value of the Proportional Unified Credit against the estate tax otherwise payable in the United States.

Further, §2013 of the Code permits a further deduction from the estate tax calculated for a deceased's estate for all or a portion of the estate tax previously paid by the estate of a deceased individual (the "Transferor") who had transferred the property to the current deceased within the past 10 years.[24]

Non-recourse mortgage financing

One other method of reducing estate tax liability is to obtain financing on the U.S. vacation property in the form of a U.S. non-recourse mortgage.[25] A non-recourse mortgage is a mortgage where the lender takes security in the U.S. vacation property and is limited to realizing on that specific piece of collateral if the borrower defaults on the mortgage. The borrower in these circumstances is not personally liable for any deficiency. From an estate tax calcula-

tion perspective, the balance of the non-recourse mortgage amount outstanding at the time of death will be deducted from the fair market value of the U.S. vacation property and will therefore directly reduce the estate tax exposure since the Proportional Unified Credit will be set off against this reduced fair market value amount.[26] If a Canadian resident is able to obtain a non-recourse mortgage in the United States secured by the U.S. vacation property, one strategy is to invest the proceeds of the loan with the objective of earning income and potentially deducting the interest payments made on the non-recourse mortgage from the individual's Canadian tax liability,[27] all the while reducing the estate tax liability in the United States.

Available Structures to Hold U.S. Vacation Property

Once the potential exposure to estate tax liability is determined with respect to the purchase of a U.S. vacation property, the following ownership structures may be considered by a Canadian resident in order to minimize or defer any potential estate tax liability. It should always be kept in mind that if the U.S. vacation property is sold prior to death, estate tax is obviously not an issue. As well, one common planning technique is for the Canadian owner of the U.S. vacation property to purchase term life insurance with a death benefit large enough to cover any estate tax due on his or her death. A brief review of alternative ownership structures and pitfalls associated with each are outlined below.

Corporate ownership

Prior to 2005, the most common structure used by Canadian residents to hold U.S. vacation property was through a Canadian corporation. Since the property was owned by a corporation, exposure to estate tax was eliminated since the death of a shareholder would not result in the disposition of U.S. situs property pursuant to the Code. As well, the corporation's shareholders could make personal use of the U.S. vacation property without the risk of enforcement of subsection 15(1) of the ITA (which would normally include in the income of a shareholder the fair market value rent for personal use of the U.S. vacation property), consistent with the Canada Revenue Agency's (the "CRA's") administrative position that no shareholder benefit would be assessed to individuals who owned shares of a "single purpose corporation" used for this purpose.[28] This administrative position was reversed effective January 1, 2005,[29] with the result that individuals will now be assessed a shareholder benefit for personal use of any property acquired by a single purpose corporation after December 31, 2004.

This tax treatment makes the holding of U.S. vacation property through a corporation the least desirable available ownership structure. Other pitfalls include much higher U.S. tax rates on the income earned by the corporation and much higher U.S. tax rates on capital gains realized on the disposition of the property (approximately double the long-term capital gains rate imposed on individuals).

Joint tenancy

In Canada, it is common for married couples to hold property on title as joint tenants. Under Canadian law, this form of ownership means that each individual is deemed to own an equal undivided interest in the entire property and upon the occurrence of the first person to die, the survivor will own 100% of the property pursuant to the right of survivorship. This form of ownership in the United States raises many potentially troubling tax issues relating to estate tax and gift tax calculations. The IRS places the onus on the joint tenants to provide proof of the exact origin of the funds utilized by each joint tenant to purchase the property.[30] If joint tenants sell the property during their lifetimes, unless they can prove to the IRS that each of them contributed equally to the original purchase price of the property, any proceeds received by the non-contributing spouse will trigger U.S. gift tax on that amount. Further, upon the death of one joint tenant, unless proof is provided that each joint tenant contributed equally to the original purchase price, the estate tax calculation payable by the deceased's estate will be based on 100% of the value of the property.[31] To make matters worse, upon the death of the surviving spouse, estate tax will be payable again based on 100% of the value of the property.[32]

It is therefore undesirable for spouses to hold U.S. vacation property as joint tenants. As an alternative, the property can be held by one spouse only (optimally, the spouse who is anticipated to die first and with the lowest worldwide estate value),[33] and that spouse can provide for the disposition of the U.S. vacation property in his or her will by providing the surviving spouse with a life interest by way of spousal trust,[34] with the property ultimately being transferred to the deceased's children. If done properly, the marital credit will still be available to the deceased's estate, and future estate tax liability will be deferred as there will be no further estate tax exposure until the death of the first child.[35] However, further complication is encountered if the wealthier spouse gifts the cash purchase price to the spouse who goes on title. In these circumstances, the application of the Canadian attribution rules[36] may attribute the capital gain realized on the sale of the property (prior to death) to the donor spouse (who gifted the cash) for Canadian tax purposes; however, the title holder spouse would have a U.S. tax liability associated with the capital gain triggered for U.S. tax purposes, with the result that no foreign tax credits would be available for set-off as the taxpayers are different people.

Tenants in common

For Canadian tax purposes, tenants in common would each hold an undivided interest in the U.S. vacation property without a right of survivorship, meaning that they can transfer their interest by a will or otherwise. If spouses have accurate documentation that proves that each contributed

their respective portion of the purchase price, then they can hold title as tenants in common, thus avoiding the potential for aggressive estate tax calculations by the IRS if they held title as joint tenants. In a situation with a number of Canadian resident individuals or couples sharing a U.S. vacation property as co-owners, an effective title strategy is for each individual (and only one representative from each couple chosen, based on the discussion above under the joint tenancy section) to hold his or her respective interest as a tenant in common. Further planning may be done to manage probate fees (and delays) in the United States by having the co-owners registered on title as joint tenants (specifying with a right of survivorship) and then severing the joint tenancy in a co-ownership agreement.[37] This will ensure that upon the death of a title holder, the probate process will be avoided in the United States (which is lengthy and expensive); however, the terms of the co-ownership agreement will ensure everyone's independent interest is protected with no right of survivorship.

Ownership by a Canadian discretionary trust

The use of a Canadian discretionary trust to own a U.S. vacation property is an effective mechanism to ensure that a wealthy individual or couple does not die holding title to valuable U.S. property (thus deferring estate tax until the deaths of the beneficiaries of the trust if they own the property). A detailed analysis of the trust structure is beyond the scope of this article; however, this strategy for dealing with estate tax does not come without complication. The trust should be settled prior to the closing of the real estate transaction and must be structured to ensure that the wealthy parents[38] who wish to keep the U.S. property out of their estate do not conduct themselves in a manner that will give the IRS authority to argue that estate tax be payable on their deaths. They must understand that the trust structure means that they do not own the property – they must not have any ownership rights; rather, the property is held by the trustees on behalf of the beneficiaries. In some circumstances, this may mean that a parent may have to pay fair market value rent to the trust for any personal use made of the property. The 21-year deemed disposition date for all trusts must also be kept in mind as well as the Canadian attribution rules when setting up the trust. Furthermore, it is prudent to ensure that the trust does not earn any income with respect to the U.S. vacation property in order to avoid filing requirements with respect to trust returns and also to ensure that no taxable benefits are inadvertently triggered.[39]

Canadian partnership

The use of a Canadian partnership to hold a U.S. vacation property is viewed by some as an effective method of planning around the U.S. estate tax regime. If Canadian residents form a partnership to hold a U.S. vacation property, then upon their deaths, they technically hold a partnership interest, not direct ownership of U.S. situs property that would attract U.S. estate tax. Further, additional steps can be taken for U.S. tax purposes, such as the ability of a partnership to elect to be treated as a corporation in the United States by using a "check-the-box" election, with the result that the corporate ownership principles outlined above will apply to circumvent the estate tax regime. There are some elaborate tax plans involving the use of partnerships that are beyond the scope of this article; however, it should be noted that there is more risk associated with the IRS looking through a partnership structure and assessing estate tax upon the death of an involved individual. Some of the uncertainty relates to ascertaining the true owner of the assets of a partnership[40] and the legal status of a partnership under Canadian law. For example, a partnership is defined in the *Partnership Act* (Alberta) as "the relationship that subsists between persons carrying on a business in common with a view to a profit". Query whether this definition is satisfied if the U.S. vacation property is used by a husband and wife solely for personal use.

Conclusion

The decision by a Canadian resident to purchase a U.S. vacation property is generally made without knowledge of the potential exposure to tax liability in the United States associated with owning U.S. situs assets. The tax planning required in order to determine the most beneficial ownership structure to hold U.S. vacation property in the specific circumstances and to implement strategies to minimize estate tax exposure makes for a very complicated house deal. One thing is certain, in all circumstances, both Canadian and U.S. tax advice should be obtained.

– John Stavropoulos, Tax Partner in the Edmonton office of Fraser Milner Casgrain LLP. Andrea Jarman, a summer student with Fraser Milner Casgrain LLP, assisted in the preparation of this article.

Notes:

[1] Subsection 2(1) of the ITA.

[2] Subsection 126(1) of the ITA. The foreign tax credit is limited to the Canadian tax that would be payable on that foreign source income in Canada, not the actual amount of the foreign tax paid, with the result that the Canadian resident pays a total tax of the higher of the two rates of tax (Canadian and foreign) on the foreign source income.

[3] §7701(*a*)(30)(A) and §7701(*b*)(1)(B) of the Code.

[4] Unless the property is held by a corporation of which the Canadian resident is a shareholder, in which case there are shareholder benefit issues (this is discussed in more detail below).

[5] Capital gains treatment assumes that the property is not held on income account (i.e., as inventory or a "flip" transaction).

[6] Subsection 70(5) of the ITA; however, subsection 70(6) permits the transfer of the property on a tax-free rollover basis to the deceased's spouse (or common-law partner) or spousal trust.

[7] IRS Form 1040NR: U.S. Nonresident Alien Income Tax Return.

[8] §1442 of the Code. In addition, the withholding agent (the person paying the rent) must also file a Form 1042-S: "Foreign Person's U.S. Source Income Subject to Withholding" with the IRS.

[9] The tax rate on a capital gain in the United States will depend on how long the property was held (holding the property for less than one year results in a higher capital gains tax rate than the rate applicable if the property was held for more than one year) and there is also a significant difference in the tax rate on a capital gain taxed in the hands of an individual versus a corporation.

[10] The calculation does not take into account the amount paid for the property or an accrued capital gain, with the result that there can be a significant tax liability associated with a property that has gone down in value since the time it was purchased.

[11] §2501(*a*) and §2511(*a*) of the Code.

[12] The 2008 gift tax lifetime exemption is $1,000,000 plus an annual exclusion of $12,000 per donee; the 2008 generation-skipping transfer tax lifetime exemption is $2,000,000.

[13] The long-term capital gains rate (property held for more than one year) for individuals in the United States (federal plus state tax) is approximately 20% in Arizona and 23% in California, for example. The current capital gains rate (federal and provincial combined) for an individual in Canada is 19.5% in Alberta and 23.2% in Ontario, for example. As previously noted, double tax is avoided by the availability of foreign tax credits that are deductible against the Canadian tax imposed on the capital gain to the extent of U.S. tax paid.

[14] The estate tax is imposed by §2101 of the Code.

[15] Where distinctions are made between legally married, common-law and same-sex couples.

[16] As inconceivable as it sounds, the estate tax top marginal rate is set at 45% for the years 2008 and 2009, is currently scheduled to be repealed for the year 2010, and scheduled to be reinstituted in 2011 at a top marginal rate of 55%; therefore, if a person dies in 2010, his or her estate tax liability will be nil. Tax practitioners anticipate that the U.S. Congress will amend the legislation prior to 2010 so that this anomaly will not become a reality. The U.S. legislation that provides for the repeal is the *Economic Growth and Tax Relief Reconciliation Act of 2001*, H.R. 1836, 107th Cong. (2001).

[17] All U.S. situs assets contained in the deceased's estate would be part of this calculation; however, for simplicity, it is assumed for the purposes of this article that the only U.S. situs asset owned by the estate is the U.S. vacation property.

[18] The calculation at this point would be the same for a U.S. citizen/resident or nonresident alien and would involve the calculation of the gross estate tax determined by applying the applicable marginal rates in accordance with §2001(c)(1) of the Code to the total fair market value of the U.S. vacation property. The marginal estate tax rates are outlined in the Table below.

[19] The Unified Credit is also calculated at this point in the same fashion for both a U.S. citizen/resident or nonresident alien.

[20] This calculation is specifically provided for in paragraph 2 of Article XXIX-B of the Canada–U.S. Tax Treaty and provides for a deduction from the estate tax otherwise payable in the amount of $13,000 or the Proportional Unified Credit, whichever is greater.

[21] The estate tax payable in the United States would normally be higher than the deemed disposition "death tax" imposed in Canada, with the result that the deceased's estate can deduct the estate tax paid in the United States against the Canadian death tax as a foreign tax credit pursuant to subsection 126(1) of the ITA.

[22] However, paragraph 8 of Article XXIX-B of the Canada–U.S. Tax Treaty does provide certain relief for "small estates" of Canadian resident decedents. It provides that if a Canadian resident's gross worldwide estate does not exceed US$1,200,000 (or its Canadian equivalent), the United States may only impose estate tax on the sale of the vacation property if any gain on its disposition would have been subject to U.S. tax under Article XIII (Gains) of the Canada–U.S. Tax Treaty.

[23] It must be emphasized that the term spouse is within the meaning of U.S. law, not Canadian law. U.S. law does not recognize common-law or same-sex partners as spouses – See the *Defense of Marriage Act*, 1 U.S.C. 7 (1994).

[24] The Transferor need not be the deceased's spouse and the amount of this credit will depend on how many years have passed since the death of the Transferor (the credit will disappear after 10 years has passed since the death of the Transferor).

[25] This is permitted by the U.S. Treasury Regulations: Treas. Reg. §20.2053-7.

[26] However, the non-recourse mortgage also affects the calculation of the Proportional Unified Credit since the value of the U.S. situs assets (the numerator) and the value of the deceased's worldwide estate (the denominator) will both be reduced, thus also reducing the Proportional Unified Credit available. Even with the reduced Proportional Unified Credit, the overall estate tax liability is reduced utilizing a non-recourse mortgage.

[27] Regardless of creditworthiness, a U.S. bank will probably not loan more than 65% of the value of the U.S. vacation property on a non-recourse basis. Therefore, over the course of time, the Canadian resident may wish to top up the non-recourse debt (by refinancing) in order to shelter as much estate tax exposure as possible.

[28] "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 606-607.

[29] Income Tax Technical News No. 31R2, "Single Purpose Corporations" (16 May 2006).

[30] §2040 of the Code.

[31] The marital credit should be available to reduce the estate tax imposed on the estate of the first spouse to die. As well, note that if for Canadian tax purposes subsection 70(6) of the ITA applies (spousal rollover), then there will be no capital gain triggered for Canadian tax purposes (which may be eliminated by claiming foreign tax credits on the estate tax paid in the United States). Therefore, it may be best to elect out of the application of subsection 70(6) for Canadian tax purposes.

[32] If the surviving spouse dies within 10 years of the death of the first spouse, the Transferor credit discussed earlier may be available to reduce the current estate tax due.

[33] This strategy will not be as effective if the "wealthier spouse" dies first and the entire estate ends up with the surviving spouse who holds title to the U.S. vacation property and will now have a much lower Proportional Unified Credit.

[34] The spousal trust should satisfy both §2056(*b*)(7)(B) of the Code and subsection 70(6) of the ITA.

[35] Alternatively, if the deceased spouse directly bequeaths the property to the surviving spouse, then the deceased spouse should be able to claim the marital credit, and if the surviving spouse dies within 10 years of that date, then a portion of the estate tax paid by the first spouse's estate may be claimed as a credit against the estate tax payable by the estate of the second spouse to die.

[36] Subsections 74.1(1) and 74.2(1) of the ITA.

[37] Ensure U.S. tax advice is obtained to confirm that this is permitted by the legislation in the particular state.

[38] It is assumed that a discretionary trust would most commonly be used when wealthy parents desire to have the trust set up with their children as beneficiaries.

[39] Pursuant to subsection 105(1) of the ITA.

[40] Whether the IRS will look through the partnership structure and determine that the individual partners in fact own the U.S. situs property for estate tax purposes.

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