Ownership of U.S. Personal Use Real Estate by Canadian Residents

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A superior line of thought
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By Abraham Leitner and Slava Sinigerska

Introduction
Ownership of U.S. vacation homes by Canadian residents has become quite common and is likely to increase in the current environment in which prices for such homes are depressed in many popular destinations. An important consequence of such cross-border ownership is the potential exposure of the Canadian resident owner to U.S. estate tax on death. Careful tax planning and a well-chosen ownership structure can reduce, and even completely eliminate, U.S. estate tax. The choice of ownership structure would depend on the particular circumstances of each case and should be made after a careful examination of numerous Canadian and U.S. tax considerations.

Status of U.S. Estate Tax
The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) adopted in 2001 phased in a series of reductions in the maximum rate of U.S. estate tax as well as a series of increases in the unified credit against the estate tax, culminating with the full repeal of the U.S. estate tax for 2010. The conventional wisdom among practitioners in the U.S. had been that Congress would act to prevent the 2010 repeal from taking effect, but this did not occur due to Congress being distracted by health reform legislation at the end of 2009. As a result, the U.S. estate tax was repealed this year. However, the provisions of EGTRRA sunset at the end of 2010, with the result that in 2011, the estate tax would come back into effect and will return to the higher rates and lower unified credit that were in effect before EGTRRA. This would bring the top marginal rate of federal estate tax to 55% and reduce the unified credit to $345,800 (sufficient to shelter the first $1 million assets in the taxable estate).

It is widely expected that Congress will amend the estate tax to reduce the rate and increase the unified credit for 2011 and subsequent years along lines not too dissimilar to the regime that was in effect in 2009, when the maximum rate was 45% and the unified credit sheltered the first $3.5 million of assets in the taxable estate. The Obama Administration’s proposed budget for 2011 and a bill currently pending in Congress propose to continue the estate tax in 2010 and beyond at the 2009 tax and unified credit rates.
effectively repealing the EGTRRA repeal. Considering that the elimination of U.S. estate tax seems unlikely in the current political and budgetary environment, it seems wise to assume for planning purposes that the estate tax will not disappear in the foreseeable future and that the general structure of the tax will remain the same. While it is uncertain whether the reinstatement of the estate tax will be retroactive to Jan. 1, 2010, for ease of discussion the balance of the discussion in this article assumes that the estate tax will remain in effect in its current form.

**General Rules**

The U.S. imposes estate tax on deceased U.S. citizens and resident aliens calculated on their worldwide assets, as well as on non-resident aliens on their assets situated in the United States. U.S. real estate owned by a Canadian constitutes a U.S.-situs asset and is thus subject to U.S. estate tax on death notwithstanding that the owner is neither a citizen nor a resident of the United States.

A Canadian who dies owning U.S. real estate would be subject to capital gains tax in Canada and estate tax in the United States. U.S. real estate owned by a Canadian constitutes a U.S.-situs asset and is thus subject to U.S. estate tax on death notwithstanding that the owner is neither a citizen nor a resident of the United States.

A Canadian who dies owning U.S. real estate would be subject to capital gains tax in Canada and estate tax in the United States. While in Canada the death of an individual triggers a disposition of the assets of the deceased and results in capital gains tax only on the accrued gains on such assets, in the United States, the estate tax is imposed on the entire market value of the assets in the estate at the time of death. Because the U.S. estate tax is imposed on the entire value of the property and at higher rates, it is usually higher than the Canadian deemed disposition capital gains tax. Thus, even with foreign tax credit relief, the deceased Canadian resident may owe significant U.S. estate tax.

The amount of the U.S. estate tax is calculated in two stages. First, the value of the “taxable estate” (equal to the fair market value of the property at the time of death minus certain deductions, such as funeral expenses, debts, marital deduction, etc.) is multiplied by the applicable tax rate, which for 2009 ranged from 18%, for the first $10,000 of assets, to a maximum of 45%, for property in excess of $1.5 million. Second, the amount thus determined is reduced by an estate tax credit called the “unified credit” and a tax credit for any state or foreign estate taxes paid.

The unified credit is different for U.S. citizens and domiciled residents on the one hand and non-resident aliens on the other. For 2009, the unified credit for U.S. citizens and residents was an amount sufficient to shelter the first $3.5 million of assets in the taxable estate. In other words, a U.S. citizen or domiciled resident who died in 2009 and whose taxable estate was smaller than $3.5 million would owe no U.S. estate tax. For a non-resident alien, however, in the absence of a tax treaty the unified credit is only $13,000 which is sufficient to shelter the estate tax on just $60,000 of assets. Another significant limitation that is often relevant for foreign owners of U.S. assets is that the IRC generally permits an unlimited deduction for assets that are transferred to the decedent’s American spouse (subject to certain limitations where the interest of the spouse is a terminable interest). This effectively permits a U.S. citizen married couple to double up on their unified credit which is accomplished by having the first spouse to die leave up to $3.5 million to the children and leaving up to an additional $3.5 million to the surviving spouse, who can then use his or her own unified credit to shelter an additional $3.5 million bequest to the children. However, no marital deduction is available for a spouse who is not a U.S. citizen.

Fortunately, Canadian residents can benefit from article XXIX B of the Canada-U.S. tax convention (the “Treaty”) which entitles them to the same unified credit as U.S. citizens on the proportion which their U.S. assets constitute of their worldwide assets. Thus, a Canadian resident can reduce his or her estate tax liability by the greater of:

- $13,000 and
- An amount equal to (x) the unified credit available to U.S. resident decedents (i.e., $1,455,800 for decedents who died in 2009)
multiplied by (y) a fraction the numerator of which is the value of the decedent’s U.S. assets and the denominator of which is the value of the decedent’s worldwide assets.

Article XXIX B also gives Canadian resident decedents the benefit of an additional credit for property bequeathed to a surviving spouse that is not a U.S. citizen. This credit is equal to the amount of the unified credit available under the treaty. In order to claim this credit, the executor of the decedent’s estate is required to forgo the benefits of any qualified domestic trust (QDOT) election (defined below) that may otherwise be available.

Possible Ownership Structures
Following is an overview of alternative ownership structures that could be used by a Canadian individual who is not a U.S. domiciled resident and the relevant U.S. and Canadian tax considerations in relation thereto. Unless otherwise indicated, the discussion assumes that the relevant ownership structure would be put into place for the initial acquisition of the property. Once the property has been acquired, a subsequent transfer of the property could raise gift tax or (if the transfer is for value) income tax issues that would need to be addressed.

Individual Ownership
Direct ownership by the individual is simple and entitles the owner to the lower U.S. federal long-term capital gains rates that is available to individuals who sell property held for more than one year. Currently, the federal rate for long-term capital gain is 15%, but is scheduled to increase to 20% following the sunset of EGTRRA, in 2011. Direct ownership does not provide any protection against U.S. estate tax. Still, it is attractive if the value of the property is modest, such that most or all of the eventual estate tax would be sheltered by the Treaty credit amount and, due to the simplicity of this alternative, it may be attractive to some individuals even if it results in some U.S. estate tax.

The following mechanisms can be used to mitigate the U.S. estate tax exposure where the U.S. real estate is held directly by the individual:

Life Insurance. Purchasing life insurance does not reduce or eliminate U.S. estate tax liability on the home in the United States. However, life insurance provides an efficient funding mechanism for the U.S. estate tax liability. It is generally possible to have the life insurance policy owned by an irrevocable trust so that the proceeds payable upon death are not includible in the estate of the decedent and are not taken into account in computing the amount of the unified credit available under the Treaty. In light of the uncertainty surrounding the future of U.S. estate tax and the possibility that a decedent’s estate could fall below the level at which the unified credit is ultimately set, this option may be particularly appealing.

Ownership by Lower Net Worth Spouse. If the Canadian individual is married, it may be better if the property is owned by the spouse with the lower net worth, so as to maximize the amount of the credit available under the Treaty. In this respect, it is important to consider the potential application of the Canadian attribution rules which provide that where property is transferred or lent by one spouse to the other, the income or capital gain from the property transferred or lent are attributed back to the transferor.

Ownership by Children. If the property is purchased by the individual’s children, then the property should not be includible in the individual’s estate as long as the individual’s use of the property is limited to staying there as a guest of the children. The funds used to purchase the property may be provided by the individual as a gift. The transfer of funds should not be made in the United States, however, otherwise the Internal Revenue Service (IRS) may take the position that it constitutes a transfer of tangible property located in the United States (i.e., a U.S.-situs asset) and is subject to U.S. federal gift tax. Also, the gift should not be conditional on the
purchase of the property. Occasional use of the house by the individual for vacations (even while the children are not using the house) should not be problematic if the visits are at the convenience and discretion of the children, but if the individual’s use is regular or extensive, then the individual could be viewed as having retained an implied right to use the property, which could result in estate tax inclusion.

Use of a QDOT and Marital Credit. If the purchaser of the property is married, measures may also be taken to defer payment of estate tax to the later of the two spouses’ deaths. This can be achieved through the use of a QDOT under U.S. law and a spousal trust under Canadian law. A U.S. marital deduction would be available for the assets that on death go to the QDOT, provided the estate makes an election to this effect. It should be noted that capital distributions from the QDOT are generally subject to estate tax, unlike in Canada, where capital distributions from qualifying spousal trusts can typically be made tax-free. As an alternative to using a QDOT, it is also possible to defer a portion of the estate tax liability up to the amount of the unified credit available under the IRC or the Treaty until the death of the surviving spouse, by taking advantage of the marital deduction under the Treaty, as discussed above. This deferral is in addition to the unified credit otherwise available.

Non-recourse Mortgage. A non-recourse mortgage can be used in order to reduce the value of the U.S. real property for estate tax purposes. If property is financed with non-recourse debt, only the value of the equity held by the decedent at the time of death (i.e. the value of the property less the mortgage) is included in the decedent’s estate. At the same time, the proceeds of the loan could be invested with the objective of earning income, which would allow the individual to deduct the interest on the loan from his Canadian taxes. However, it may be difficult to obtain this kind of financing, especially in the current credit environment, and most financial institutions would only grant a non-recourse mortgage for a fraction of the value of the property, which usually does not exceed 65%. A non-recourse loan can be contracted with a non-arm’s-length party, but one must be able to show that the loan was bona fide and under normal commercial terms. This involves charging interest, which may increase the taxable income of the recipient. A non-recourse mortgage cannot cover the entire value of the property, so if the remaining value exceeds the amount sheltered by the Treaty credit amount, estate tax would not be entirely eliminated. Furthermore, as real estate prices go up and the mortgage is being repaid, the value of the property subject to U.S. estate tax would increase.

Tenancy in Common. Tenancy in Common (i.e. undivided co-ownership) by the spouses, and possibly together with other family members, may also be helpful in reducing U.S. estate tax, or eliminating it on a modestly valued property. In determining the value for estate tax purposes, U.S. courts and the IRS often allow a discount of up to 15% for the fact that a deceased person owned only a fractional interest in a property. The ability to use a discount will be determined by the IRS or a court based on evidence showing that such a discount is appropriate for the particular property or in the particular market where the property is located. If this strategy is pursued, the respective wills of the spouses should provide that their tenancy in common interests would go to their children, such that the discount will also be available for the interest of the second spouse to die and the children would inherit a cost base equal to the value at the date of death.

In the above strategy, it is important that each of the co-owners contribute funds for the purchase of the property. If some of the family members do not possess sufficient funds, a parent may gift to them the necessary amounts. This should be done prior to the acquisition. As noted above, the transfer of funds should not be conditional on purchasing the property. If the transfer of funds takes place outside the United...
States and is not conditional, the gift should not be subject to U.S. federal gift tax.

The other form of undivided co-ownership often used in Canada is joint tenancy. The right of survivorship associated with joint tenancy means that in case of death of one of the co-owners, the other co-owner becomes the sole owner of the property. The consequence of this for U.S. estate tax purposes is that upon death of one of the co-owners, the estate tax would be calculated on the entire value of the property unless the co-owners can prove to the IRS that they have contributed equal funds to acquire it. In addition, the property would be subject to estate tax a second time upon the death of the surviving co-owner.

**Non-U.S. Corporation**

The relevant U.S. rules that define U.S.-situs assets exclude shares of a foreign corporation. Thus, if instead of owning U.S. real estate directly, a Canadian resident owns such real estate through a corporation, no U.S. estate tax would apply. For this reason, before Jan. 1, 2005, it was common for Canadian individuals to hold U.S. real estate through single-purpose corporations (SPC). Prior to that date, the Canada Revenue Agency (CRA) had an administrative policy that if certain conditions were met, the shareholders of SPCs were not assessed a taxable benefit in Canada for their personal use of the vacation properties owned by their corporations. In 2004, the CRA changed its administrative policy and started assessing taxable benefits where the shareholder of an SPC uses the real property thereof for personal purposes rent-free. The use by Canadian residents of SPCs for holding U.S. real estate has thus become impractical.

There are additional disadvantages to using a corporation as a vehicle for holding U.S. real estate. When the property is sold, the corporate income tax rate on any long-term capital gain (currently 35%) would be significantly higher than the individual rate (currently 15%).

**Trust**

A discretionary inter vivos trust can be used as a vehicle for holding U.S. real estate without incurring U.S. estate tax. To this end, a discretionary inter vivos trust (the "Trust") is settled in favour of the spouse and descendants of the Canadian resident individual. The necessary funds to purchase the U.S. property are gifted to the Trust and the Trust then purchases the property. It is important to ensure that the U.S. real estate would be purchased directly by the Trust rather than being transferred to it by the settlor, as a sale for value would be taxable if the property has appreciated, and a gift would be subject to U.S. gift tax.

The Canadian resident individual should not be a beneficiary of the Trust, as an interest in the Trust, even if only a discretionary one, coupled with the use of the Trust property by the settlor/contributor, could be viewed as a "retained interest" and thus included in the U.S. estate of the settlor/contributor. To avoid any risk that the settlor/contributor could be found to have retained control of the Trust assets, the settlor/contributor should generally not be a trustee and should generally not have the power to appoint or replace the trustees (unless the power to appoint replacement trustees is limited to independent trustees). If some of the beneficiaries of the Trust are also trustees, they cannot participate in any decisions relating to the distribution of property under the Trust to prevent a finding that those assets have become part of their estate.

The above structure should ensure that the Canadian resident individual would not have an interest in the Trust and in its underlying assets, and hence the assets in the Trust should not be subject to estate tax upon death. The IRS has held that the rent-free use of the property by the settlor by virtue of being married to a beneficiary does not constitute a retained interest for estate tax law purposes. No U.S. estate tax would be payable on the Trust assets on the death of a beneficiary either, since such beneficiary cannot be considered to have retained an interest in such assets considering
that he or she has never owned any of the Trust assets. The Trust itself is also not subject to U.S. estate tax.

For Canadian tax purposes, there should be no taxable benefit conferred on the beneficiaries of the Trust, since the CRA takes the position that no benefit should be assessed where personal use property is owned by a trust, if the Trust owns the property principally for the personal use and enjoyment of the beneficiary or a person related thereto.21 An advantage of holding U.S. real estate through a trust as compared to a "check the box" partnership or a corporation is that if the property is sold while being owned by the Trust, any gain would be taxed in the United States at the lower capital gains tax rate for individuals, currently 15% compared to 35%.

In planning the ownership structure through a trust, consideration should be given to the "21-year rule" under Canadian tax law, whereby a deemed disposition occurs on the 21st anniversary date of a trust. Such deemed disposition and the eventual capital gains tax resulting therefrom can be avoided by winding-up the Trust prior to its 21st anniversary date and distributing the assets thereof on a rollover basis to the beneficiaries assuming the beneficiaries are at that time Canadian residents.22 The beneficiaries to whom the U.S. real property would be distributed would, however, be subject to U.S. estate tax on death. Depending on the age of the beneficiaries, payment of Canadian tax on capital gains may be preferable over a tax-deferred distribution to the beneficiaries resulting in eventual exposure to U.S. estate tax, especially if U.S. capital gains tax can also be triggered in the same year and claimed as a foreign tax credit in Canada.

The disadvantage of ownership through a trust is that the Canadian resident must give up ownership and control of the property in favour of his or her spouse and children. As the settlor/contributor would not be a beneficiary of the Trust, he or she would depend on his or her spouse and descendants for being able to use the property. Also, as discussed above, where the spouse is not a beneficiary the settlor would not be able to use the property in a manner that suggests the settlor retained an implied right to use it, or else the property will be includible in the settlor's estate. Careful consideration must therefore be given to the state of family relations.

In order to mitigate the above concerns and to secure a limited legal right to use and enjoyment of the U.S. property, the Canadian resident may wish to acquire, in his individual capacity, a small tenant in common (undivided ownership) interest in the property jointly with the Trust. The individual's tenant in common interest would be subject to U.S. estate tax, but such tax would presumably be shielded by the Treaty credit amount, or if this is not the case, life insurance can be purchased to cover the U.S. estate tax exposure. If the individual's use of the property is not disproportionate to the individual's ownership, then the portion of the property that is owned by the Trust should not be includible in the individual's estate.

**Partnership**

A Canadian limited partnership can also be used to hold U.S. real estate, with the individual as the limited partner and a corporation wholly owned by the individual as the general partner. The logic behind the use of a partnership is that the partnership interest in a non-U.S. partnership should not constitute a U.S.-situs asset and would therefore not be subject to U.S. estate tax. Furthermore, the use of a partnership structure avoids shareholder benefit issues in Canada.

Attention must be paid to meeting the requirements for the existence of a partnership under the law of the Canadian province where the partnership would be created. In the common law Canadian provinces, a partnership would only exist if the parties are carrying on business in common with a view to profit. In the province of Quebec, a partnership exists where the parties carry on an activity together with a profit motive.23 Holding personal use real estate may not be sufficient to meet the "for profit" requirement, as it can be
argued that the purpose of the partnership is to provide one of the partners with the use of a vacation home rather than to invest in income-earning real estate. At the same time, it would be disadvantageous for the partners to argue that the purpose of purchasing the property was to sell at a gain, as this could make the ownership of the property an adventure or concern in the nature of trade for Canadian tax purposes and trigger income treatment upon an eventual sale. In order to satisfy the “for profit” requirement, the partnership can acquire some marketable securities, for which it would be easy to assert that they are being held for the purpose of making a profit. As for the requirement that the partnership carries on a business, it is questionable whether holding personal use property for the use of one of the partners satisfies this requirement. In the province of Quebec, there is no requirement that the partners carry on a “business” together and it is sufficient if the parties carry on an “activity.” The threshold for the existence of an “activity” is low, and holding personal investments meets this threshold. Thus, the use of a Quebec partnership may be preferable over a partnership of another jurisdiction. Another alternative is to use a partnership formed in a jurisdiction outside of Canada that does not have such an activity requirement.

An important planning concern is whether the partnership should “check the box” to be treated as a corporation for U.S. tax purposes. The importance of this question stems from the fact that the IRS does not have a clear policy as to the situs of a partnership interest, such that if the partnership does not check the box, a possibility exists that the IRS could find the partnership interest to be situated where the partnership’s assets are located, namely in the United States. The option of not checking the box has the advantage that the lower capital gains rate for individuals (currently 15%) would be available on the eventual sale of the property.

If the partnership checks the box, it will be considered a corporation for U.S. tax purposes, such that upon death, the limited partner would be considered to own shares in a non-U.S. corporation, which are clearly not U.S.-situs. As a result, no U.S. estate tax would apply to the interest in the partnership. The disadvantage is that the higher corporate capital gains rate (currently 35%) would apply if the partnership sells the property to a third party.

Conclusion
The future of the U.S. estate tax regime is uncertain. While the U.S. legislature may take action to adopt long-term low rates and high exemptions in the foreseeable future, it is still important to structure ownership of U.S. real estate by Canadian residents in a way that minimizes estate tax exposure. A careful examination of the individual circumstances of each case should help in determining the most appropriate and efficient ownership structure for each acquisition.

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Endnotes
1 The present article is limited to the situation where the Canadian resident is not a U.S. citizen or a domiciled alien in the United States. An individual has a domicile in the United States for U.S. estate tax purposes if he or she has lived in the United States, even for a brief period of time, with no definite intention of moving from there. Treas. Reg. section 20.01(b). The determination whether someone is domiciled in the United States is based on a facts and circumstances test.
3 Internal Revenue Code (IRC), section 2031(a) and section 2103.

5 State death taxes may also apply in many cases.

6 IRC section 2102(b)(2).

7 IRC section 2056.

8 As discussed above, the unified credit under the Treaty is smaller if the decedent owns more non-U.S. situs assets.

9 The individual’s use of the property owned by the spouse should not be treated as a retained interest for purposes of section 2036. See footnote 20.

10 Sections 74.1 and 74.2 of the Income Tax Act, RSC 1985, c.1 (5th Supplement), as amended, hereinafter referred to as the “Act.” These attribution rules do not apply in case of a transfer for fair market value consideration or a loan made for at least the current prescribed rate of interest (see section 74.5 of the Act).

11 Art. XXIX-B (3) and (4) of the Canada-U.S. tax convention. The conditions set out in XXIX-B(3) must be met and the estate must file an election and waive any benefits of any estate tax marital deduction under U.S. domestic law.


13 IRC section 2040.

14 IRC section 2104.


17 Case law in the United States supports treating the rent-free occupancy of corporate property by a shareholder as a constructive dividend, but generally not as resulting in imputed rental income to the corporation. See, e.g., Sparks v. Comm'r, TC Memo 1988-492. See also Transport Manufacturing & Equipment Co. v. Comm'r, 434 F2d 373 (8th Cir. 1970), affg. TC Memo 1964-190; Yarbrough Oldsmobile Cadillac Inc., et al. v. Comm'r, TC Memo 1995-538; Nicholls North, Buse Co. v. Comm'r, 56 T.C. 1225 (1971); Offshore Operations Trust v. Comm'r, TC Memo 1973-212. A dividend from a foreign corporation would not be subject to U.S. withholding tax, though, so this is not problematic.

18 IRC, section 2036.

19 This structure should also avoid the application of the attribution rules in subsection 75(2) of the Act, which would otherwise prevent the tax free rollover of property from the trust to anyone other than the person from whom the property was received or a spouse.


21 Technical Interpretation 9707317, dated Aug. 26, 1997. A taxable benefit may be conferred on the beneficiary if an amount for the upkeep, maintenance or taxes of the property is paid out of the income of the Trust (section 105(2) of the Act). If, however, the Trust does not have any income, as would most likely be the situation with a trust holding U.S. personal use real estate, there would be no taxable benefit if the Trust pays the expenses for the property. See Technical Interpretation 2006-017326117, dated Oct. 19, 2006 (in French only).

22 Subsection 107(2) of the Act. IRC sections 643(e), 897(e)(1) and 897(g).

23 Civil Code of Quebec, article 2186. The profit-making requirement comes from the words “to share any resulting pecuniary profits,” and from an a contrario reading of the definition of “association” in the second paragraph of article 2186.

24 Holding investments constitutes an “activity” even if such activity does not consist in an enterprise. See Commentaires du ministre de la Justice on article 2186.