

Breaking Developments in Tax Law

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Tax Pitfalls for Canadian Buyers of U.S. Recreational Property

With the waning value of the U.S. dollar, an emerging trend among foreign investors is to acquire U.S. real estate. Consistent with this inbound investment trend, a number of Canadians are purchasing U.S. recreational property.

Overview

Various ownership arrangements are available for acquiring and holding U.S. real estate. Since each investor is unique, selecting the optimal ownership arrangement will depend on a number of factors, including the owner's intended use of the property, duration of intended ownership, plans for future disposition to family members, etc.

Cross-border purchases of U.S. real estate can spawn unanticipated income, death/estate and gift tax issues under foreign and U.S. laws. Examples of tax complications associated with U.S. property ownership include:

- If the recreational property is leased or sold, resulting income tax obligations;
- Ownership of the recreational property at death or gifting of an interest during life;
or
- State and local transfer taxes on acquisition and disposition of the property.

The summary below describes five arrangements commonly used when acquiring U.S. recreational property and some of the tax issues that a Canadian buyer should consider.

For illustrative purposes, assume that the purchase of U.S. recreational property is made by "A" and "B," husband and wife, both of whom are Canadian citizens and residents. In each arrangement, the recreational property is located in Washington state.

A. Direct Ownership of U.S. Recreational Property

The simplest way to acquire recreational property is to take title directly in the name of the purchaser. For example, A and B might purchase recreational property in Washington state, taking title in both of their names. Although straightforward, potential tax consequences of this approach include:

- Income Taxes
 - Gain from the sale of the recreational property will be subject to income tax in both the United States and Canada. Under the Foreign Investment in Real Property Tax Act (“FIRPTA”), gross proceeds (not just gain) from the sale may be subject to a flat 10 percent U.S. withholding tax.
 - Any rental income generated from the recreational property will be subject to income tax by both the United States and Canada. Unless A and B make an affirmative election to treat the income as effectively connected with a U.S. trade or business, the gross rental income will be subject to a flat U.S. tax rate of 30 percent, withheld by the payor.
- Death and Gift Taxes
 - U.S. federal and Washington state estate taxes will be assessed on the value of the decedent’s interest in the recreational property at death. If A and B make lifetime gifts of an interest in the recreational property, U.S. federal gift tax will apply to the amount of the gift in excess of the applicable U.S. exclusion.
 - In Canada, gratuitous transfers and property owned at death are subject to “deemed sale” treatment and a corresponding capital gains tax.
- Washington State and Local Transfer Taxes
 - Washington state and local transfer taxes are likely to apply to the acquisition and disposition of recreational property.

B. Ownership Through a Canadian Corporation

A and B might form a Canadian corporation (“CANCO”) and CANCO, in turn, can purchase and hold title to the property. While this ownership arrangement shields A and B from U.S. federal and Washington state estate tax as well as U.S. federal gift tax, additional considerations include:

- Corporate-Level Taxes
 - Income earned by CANCO on the sale of the recreational property will be subject to income tax in both Canada and the United States. Gain from the sale will be considered income effectively connected with a U.S. trade or business, subject to U.S. federal income tax at progressive tax rates, and, unless an applicable exemption applies, an additional U.S. federal branch profits tax, reduced to 5 percent by reason of the U.S. – Canada Income Tax Treaty. Under FIRPTA, gross proceeds from the sale may be subject to a flat 10 percent U.S. withholding tax.
 - Any rental income will be subject to both U.S. and Canadian income tax. The *gross* rental income will be subject to a flat U.S. tax rate of 30 percent, withheld by the payor, unless CANCO elects to have the rental income treated as income effectively connected with a U.S. trade or business. If the election is made, the net rental income will be taxed at the progressive U.S.

federal tax rates, and may be subject to an additional U.S. federal branch profits tax reduced to 5 percent by reason of the U.S. – Canada Income Tax Treaty.

- Impermissible Personal Deductions for Interest and Carrying Costs
 - Because CANCO holds legal title to the recreational property, A and B are not entitled to deductions for mortgage interest and other carrying costs associated with the property.
- Income Imputed for Shareholder Use
 - As shareholders of CANCO, A and B may be subject to both Canadian and U.S. income tax on the value of their personal use of the recreational property.
- Death and Gift Taxes
 - A gift of CANCO stock, or ownership of such stock at death, may be treated as a taxable “deemed sale” under the Canadian income tax laws.
- Washington State and Local Transfer Taxes
 - The sale of a 50 percent or greater interest in CANCO over a 12-month period will be considered a “sale” of the recreational property which triggers Washington state and local transfer taxes.

C. Ownership Through a Trust

A and B might hold title to the recreational property through a trust. In this scenario, A and B form a U.S. or Canadian trust to hold legal title to the recreational property for the benefit of designated person(s). A trustee, who can be A or B or both, is appointed to manage the affairs of the trust pursuant to the directions specified by A and B in the trust document.

A and B, through the trust document, can dictate the use, enjoyment and ultimate disposition of the property. For example, A and B might draft the trust document to provide for their personal use and enjoyment of the recreational property during their lives and designate that the property be distributed to their children or to a charity upon their deaths. Among the issues associated with a trust are:

- Unintended Jurisdiction
 - Canada and the United States have distinct jurisdictional tests to determine the residency of a trust for tax purposes. Absent proper planning, one might inadvertently establish a trust treated as a domestic trust for U.S. federal tax purposes, but also considered a Canadian trust under the laws of Canada. As described below, the trust’s residence will impact its taxation under Canadian and U.S. tax laws.

- Income Taxes
 - If the trust is considered a Canadian trust, rental income generated from the recreational property will be subject to U.S. federal income tax as well as Canadian income tax. The gross proceeds will be subject to U.S. federal income tax at a flat rate of 30 percent, withheld by the payor, unless the trust makes an affirmative election to treat the rental income as effectively connected with a U.S. trade or business.
 - For U.S. federal income tax purposes, unless A and B are considered the tax owners of the trust property, trust income is taxable to the trust if accumulated or to the beneficiaries to the extent currently distributed. Income accumulated by a Canadian trust, rather than distributed in the year earned, can be subject to a complicated U.S. federal income tax regime that imposes an interest charge, in addition to income tax, on a future distribution of such income to U.S. beneficiaries.
 - Gain from the sale of the recreational property will be subject to income tax in both Canada and the United States. For U.S. federal tax purposes, any gain will be considered effectively connected with a U.S. trade or business and thus subject to U.S. federal income tax at the progressive U.S. federal income tax rates. If the trust is a resident of Canada, under FIRPTA, proceeds from the sale may be subject to withholding.
 - In Canada, a trust is deemed to have disposed of all of its property in a taxable transaction every 21 years.
- Estate/Death, Gift and Generation-Skipping Transfer Taxes
 - By retaining certain control over the trust, such as the power to designate beneficiaries, or the power to revoke the trust, A and B will be treated as the owners of the recreational property for U.S. federal estate tax purposes.
 - Contribution of property to the trust may be subject to U.S. federal gift tax, depending on the terms of the trust, to the extent it exceeds the U.S. applicable exclusion limit.
 - If the designated trust beneficiaries include the grandchildren of A and B, or later generations, A and B may be subject to U.S. generation skipping transfer taxes.
- Washington State Transfer Taxes
 - A transfer of a 50 percent or greater beneficial interest in the trust over a 12-month period will be considered a “sale” of the Washington recreational property, which triggers Washington state and local transfer taxes.

D. Ownership Through a Qualified Personal Residence Trust

A and B might consider a Qualified Personal Residence Trust (“QPRT”) to hold the recreational property. A QPRT is a narrowly focused trust designed to hold legal title to a personal residence, limited to the personal benefit of A and B and their dependents over a specified term of years. In

addition to the considerations presented for regular trusts as discussed above, the following limitations should be considered:

- **Limitations on Trust**
 - Generally, the QPRT cannot hold any asset other than a single personal residence and cash not to exceed an amount necessary to accommodate expenses of the trust and improvements to the residence.
 - The residence cannot be occupied by anyone other than A and B and their dependents and must be available at all times for use by A and B as a personal residence. After the term specified in the trust expires, A and B may continue to use the residence but must pay rent at market value.
 - The recreational property cannot be transferred during the term established by A and B in the trust. After expiration of the term, the QPRT cannot transfer the property in any manner to A or B.
 - A transfer of the residence to the QPRT constitutes a gift of a future interest in the property (i.e., ownership of the property upon expiration of the specified term), subject to U.S. federal gift tax to the extent it exceeds the U.S. applicable exclusion.
 - If A and B die during the term established in the trust, their interest in the recreational property will be subject to U.S. federal estate tax. After expiration of the original term, the property may still be included in A and B's gross estate for U.S. federal estate tax purposes if they remain beneficiaries of the trust.

E. Ownership Through a “Stopper” Corporation

Ownership of the recreational property through a “hybrid entity” may provide flexibility for A and B to achieve their investment goals. In this ownership arrangement, A and B form a partnership under Canadian law that is considered a corporation under U.S. federal tax law (“Stopper”). By holding the recreational property through Stopper, considerations include:

- **Income Taxes**
 - For Canadian income tax purposes, income generated from the recreational property is taxable to A and B, as partners of Stopper.
 - From a U.S. federal income tax perspective, Stopper is a taxable entity. Income from the sale of the property is income effectively connected with a U.S. trade or business and thus subject to U.S. federal income tax at the progressive U.S. federal income tax rates. Under FIRPTA, gross proceeds from the sale may be subject to a flat 10 percent U.S. withholding tax.
 - If the recreational property is rented, the gross rental income will be subject to U.S. federal income tax at a flat rate of 30%, withheld by the payor, unless Stopper makes an affirmative election to have the rental income

treated as income effectively connected with a U.S. trade or business. If such an election is made, the net rental income will be subject to U.S. federal income tax at the progressive U.S. federal income tax rates in addition to a potential 5 percent U.S. federal branch profits tax under the United States – Canada Income Tax Treaty.

- Expenses for mortgage interest and carrying costs associated with the property are deductions of Stopper and not A and B.
- Death and Gift Taxes
 - Because Stopper is treated as a Canadian corporation for U.S. federal tax purposes, A and B avoid U.S. federal gift and estate tax exposure but may still be subject to the Canadian capital gains tax based upon their ownership of Stopper at death or a gift of an interest in Stopper.
- Washington Transfer Taxes
 - The transfer by A and B of a 50 percent or greater interest in Stopper will trigger Washington state and local transfer taxes based on the recreational property's fair market value.

Summary

As indicated above, each ownership arrangement poses unique tax considerations and ownership limitations. By addressing questions regarding ownership goals at the time of purchase, ownership objectives can be achieved while minimizing U.S. and Canadian income, death and gift tax consequences.

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