Canadians, U.S. Real Estate and U.S. Estate Tax

September 17, 2008

TAX

AUDIT ▪ TAX ▪ ADVISORY

Agenda

- Moving to the U.S.:
  - Tax on Emigration, Principal Residence, Gift Tax, Estate Taxes.
- Buying U.S. Vacation Property:
  - Residence, Owning U.S. Real Estate, Renting U.S. Real Estate, Estate Taxes, Gift Taxes, Investing Alternatives.
- Investing in U.S. Income Earning Property:
  - Income Tax and Withholding Tax Basics;
  - Scenarios – Investment Alternatives; and
  - Scenarios – Estate Alternatives.

Moving to the U.S.

An Introduction to Federal Tax on U.S. Property and Estates

Canadian Tax on Departure: Basic Rules

- Deemed sale of all assets at fair market value on the date of emigration, except for:
  - Canadian Real Estate.
  - RRSPs.
  - Property used in a business in Canada.
  - Certain other specific exceptions.

- Will lose access to the following after emigration:
  - Principal residence exemption.
  - Capital Gains exemption of $750,000 (CDN).

- Filing requirements on emigration:
  - Section 116 clearance certificate and/or withholding tax.
  - Post 2008 rules relax S.116 filing requirements for Taxable Canadian Property *(i.e.,* shares of private corporation and CDN real estate).

Principal Residence

- Canada Rules:
  - Normally 100% exempt from tax, if minimal land involved.
  - Vacation cottage can qualify as principal residence.

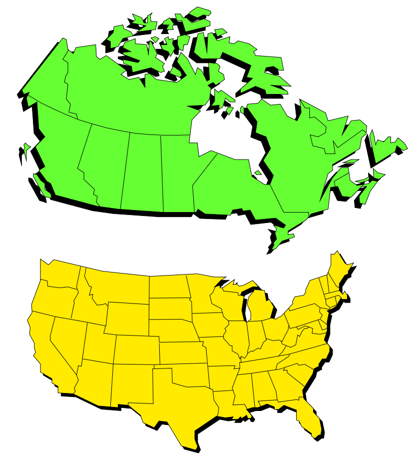
- U.S. Rules:
  - $250,000 (USD) gain excluded ($500,000 (USD) if filing jointly with spouse).
  - Must hold as principal residence for at least 2 years during 5 year period ending on the date of the sale or exchange.
  - Vacation cottage usually excluded.

Apples to Oranges: Miscellaneous Differences

Canada Versus U.S. Tax Deductions For Individuals

Item	**Canada**	**United States**
Mortgage Interest	Non-Deductible	Deductible
Property Taxes	Non-Deductible	Deductible
State/Provincial Tax	Non-Deductible	Deductible
IRA Contributions	Non-Deductible	Deductible
Interest in excess of investment income	Deductible	Non-Deductible
RRSP Contributions	Deductible	Non-Deductible
Charitable Donations	75% of income	30% - 50% of income

Gift Tax



- **Canada Rules:**
  - Deemed sale of all assets gifted (giver is liable).
  - Tax applies to 50% of any capital gains that arise.
- **U.S. Rules:**
  - Gift tax applies at 18% - 45% (giver is liable).
  - Tax applies to the value of item gifted.
- **Exemptions from U.S. Gift Tax:**
  - A lifetime exemption of $1M (USD) is available, but reduces the $2M (USD) exemption.
  - $12,000 (USD) exemption per recipient per year.
  - Gifts to U.S. citizen spouse are excluded.
  - Gifts to non-U.S. citizen spouse eligible for $128,000 (2008) exclusion.

Estate Tax for U.S. Residents/Citizens

- Canada Effect:
  - Deemed sale of all assets on death.
  - Tax applies to 50% of any capital gains that arise.
  - Life insurance excluded.
- U.S. Effect:
  - 45% tax on the fair value of your worldwide assets in excess of $2M (USD).
  - Exemption increases to $3.5 M (USD) in 2009.
  - Estate tax repealed in 2010.
  - Estate tax applies at 55% of the fair value of worldwide assets in excess of $1M (USD) in 2011.
  - Expect a post-election bill could alter these rules.
  - Life insurance is included.

Estate Tax Deductions for U.S. Residents/Citizens

- Enhanced Unified Credit:
  - $2M (USD) exemption from estate tax.

- Marital deduction:
  - Equal to 100% of estate value where property transferred to a U.S. citizen spouse.

- Canadian Income Taxes:
  - A deduction/credit is available for any taxes covered under the Treaty.

Other Estate issues

- **Time delays in transferring property:**
  - Probate.
  - Transfers of stock by U.S. transfer agents.
  - Problems left for spouse or Executor to address.

- **Expense and hassle of filing U.S. estate and state death tax returns:**
  - Examination of all US estate tax returns by IRS attorneys.

- **Disclosure of worldwide assets on U.S. estate tax return to obtain treaty benefits.**

- **Some states have estate taxes as well.**

Buying U.S. Vacation Property

Dealing with Two Governments

Tax Status and Residence

- Generally, Green-Card Holders and U.S. Citizens, regardless of taxable residence, are subject to U.S. tax on worldwide income.

- Foreign nationals are subject to U.S. and State tax:
  - On their worldwide income if they are resident in the U.S.
  - On their U.S. source income if they are not resident in the U.S.

- Foreign Tax Credits are available In Canada for U.S. taxes paid on U.S. source income:
  - No Canadian foreign credit for gift tax.

- Residency and Tax Status are IMPORTANT!

Residence (U.S. income tax purposes)

- A substantial presence in the United States deems you to be a U.S. resident. The substantial presence test has two parts:

1) > 183 days in the U.S. in the current year test → U.S. resident:
   - Subject to tie-breaker rules under the Treaty.

2) 183 cumulative 3 year test if > 31 days in the U.S. in the year:
   - 100% of the U.S. days in the current year, plus.
   - 1/3 of the U.S. days in the prior year, plus.
   - 1/6 of the U.S. days in the second preceding year.

- If the total number of days is > 183, → U.S. resident for the current year, unless a "closer connection" form is filed with the IRS.

Substantial Presence: Calculation

- Under the substantial presence test, Individual was in the U.S. for > 183 days in the last three years:

Year	Days / Rate	Calculation
Current Year	132 / 1	132
Prior Year	132 / 3	44
2nd Preceding Year	132 / 6	22
		198

Owning / Selling Rental property

Rental Real Estate:

- 30% withholding tax on gross rental income, or elect to file on net basis:
  - Individuals must file return within 16 months of due date or lose all deductions.

Sale of Property:

- Individuals: long-term capital gains rates – 15%.
- Corporations: 35%.
- No loss carrybacks in the U.S.
  ($3k against other income per year CF).
- Possible foreign exchange gain/loss:
  - For instance, gain in Canada, Loss in U.S. means no foreign tax credits.
- State taxes vary.
- 10% withholding on sale (FIRPTA withholding):
  - Not final tax – must file return and compute final tax; and
  - Similar State tax may also apply.

Investing With Others

- Value allocated based on initial contributions:
  - Need to keep detailed records!
- Joint Tenancy (*i.e.*, spouse):
  - Proceeds received by non-contributing spouse will be subject to gift tax;
  - 100% of property may end up in the estate of the first to die; and
  - Cost base rolls over, so estate tax on 100% of the value will apply on the second to die.
- Tenants in Common (*i.e.*, ownership with friends):
  - Problems associated with joint tenancy are avoided;
  - But, all tenants are tied into probate process if one tenant dies; and
  - Planning can mitigate probate problems.

Investing Through A Trust

- **Complex, as trust rules vary between Canada and U.S.:**
  - No U.S. income tax advantage to accumulating income in a trust.
- **If trust survives death of settlor:**
  - 21 year life of trust (Canadian); and
  - Should avoid Rental of property, otherwise subject to U.S. trust filing requirements.
- **If life beneficiary dies before settlor:**
  - Settlor would have to rent property to use it, or facts may suggest it is actually part of settlor’s estate.

Residence (U.S. Estate and Gift Tax Purposes)

- Residence means Domicile
  - Physical presence;
  - Intent to remain indefinitely; and
  - Greencard status.

- Residence status is of enormous importance to the determination of whether all world-wide assets or only U.S.-situs assets are subject to estate tax.

Gifting U.S. Property: Non-Residents

- **Canada:**
  - The Cost base of Gifted Property becomes the FMV at time of the gift; and
  - No treaty reduction or Canadian credit for U.S. gift tax.

- **U.S.:**
  - The Cost base of Gifted Property transfers to the recipient; and
  - Gift tax and Generation skipping transfer tax (GSTT) may apply.

- **Double / Triple Tax:**
  - U.S. Gift tax / GSTT on initial gift;
  - Canadian tax (no U.S. credit) on taxable capital gain; and
  - U.S. income tax applies when recipient sells the property.

- **Gift tax does not apply to gifts of U.S. securities, gifts to charities and political parties, or amounts paid directly to an institution for tuition or medical expenses.**

Estate Tax: Non-Residents

- U.S. estate tax applies to property situated within the United States:
  - U.S. Real Property;
  - Tangible Property in the U.S.;
  - Shares of U.S. Corporations;
  - U.S. Debts, Pensions and Annuities; and
  - Interest in partnerships carrying on a U.S. business.

- U.S. estate tax does not apply to property situated outside the United States, including:
  - Shares of a Foreign Company;
  - U.S. and foreign bank deposits;
  - Portfolio debt and bonds; and
  - Life insurance.

Estate Tax: Non-residents

- $2M unified tax credit prorated on value of U.S. to Worldwide Assets
  - Based on Treaty.
- 100% Marital deduction available to non-residents if assets transferred into a qualified domestic trust (QDOT):
  - Must have at least 1 U.S. trustee;
  - Estate tax applies to any distributions from the trust;
  - Defers estate tax until distribution or death of surviving spouse; and
  - No access to $2M unified credit or marital credit.
- Marital credit available where non-U.S. spouse is the recipient:
  - Equal to the unified tax credit;
  - Requires election, and waiving of marital deduction;
  - Marital deduction must have otherwise been available; and
  - Open to U.S. citizens and Canadians.

Investing In U.S. Income-Earning Property

Making a Profit or Loss in the U.S.

The Basics: Income Tax

- Canada Basics:
  - Integration means indifferent to earning funds personally, or in corporation;
  - Earnings from U.S. corporation may be received tax free, or tax credits may apply;
  - FAPI – immediate Canadian tax – may apply even if there is no distribution of U.S. earnings. Applies only to Passive Income *(i.e.,* rental operations with less than 6 full time employees).

- U.S. Basics:
  - No concept of integration;
  - U.S. residents often use S-Corporations – flow through for U.S. tax purposes;
  - Foreign investors cannot use S-Corporations;
  - 35% corporate tax – applies to income AND CAPITAL GAINS; and
  - State tax may apply.

The Basics: Withholding Tax

- Dividends:
  - 5% withholding where corporation owned >10%; and
  - 15% withholding where corporation owned <10%.

- Interest:
  - Currently at 10%, but after Protocol is ratified:
    - Withholding on Arm's length interest will be eliminated the second month after ratification.
    - Withholding on non-arm's length interest will be reduced to 7%, 4% and then nil over three years.

A Comparison of Tax Rates:

	Earned Income		Capital Gains on Property	
Entity	**Active**	**Passive**	**Active**	**Passive**
LLC	60% - 66%	60%	47% - 66%	47% - 66%
Canco	54%	62%	45%	45%
USco	66%	66%	66%	66%
Canco / USco	54%	54%	54%	54%
Canadian Partnership	44%	44%	22% - 40%	22% - 40%
Individual	44%	44%	22% - 40%	22% - 40%

Note: 2008 BC and Federal rates used. All percentages rounded to the nearest 1%.

Estate Tax: The Other ½ Of The Coin

- Sell property before death; or
- Beneficial to invest into the U.S. through a Canadian corporation, from an Estate Tax perspective:
  - Annual compliance; and
  - Taxable Shareholder benefits.
- Canadian Limited Partnership:
  - Can elect to be treated as a US Corp, but would increase income tax if election made pre-death. May be possible post-death (seek advice).
- Life Insurance:
  - Will reduce allocation of $2M (USD) credit as included in worldwide non-U.S. assets; and
  - Possible non-deductibility of premiums.

Entity	**Estate Tax**
LLC	Possible
Canco	N/A
USco	Yes
Canco / USco	N/A
Canadian Partnership	Possible
Individual	Yes

Final Observations

- **U.S. assets that generate income from property income should be held personally or through a limited partnership:**
  - If held personally, subject to Estate Tax; and
  - May be subject to estate tax or corporate tax in a partnership, if not set up properly.

- **Depending on the structure, exiting from the U.S. can create painfully high taxes on fully-distributed income from capital gains:**
  - Sell at individual level to access preferential U.S. capital gain rates and/or treaty exemption.

Jeremy Bergen, CA
Manager, U.S. Tax
Burnaby
604-527-3781
jibergen@kpmg.ca

David Turchen, CA, CPA
Manager, U.S. Tax
Abbotsford
604-854-2273
dturchen@kpmg.ca

- Any advice herein is based on the facts provided to us and on current tax law including judicial and administrative interpretation. Tax law is subject to continual change, at times on a retroactive basis and may result in incremental taxes, interest or penalties. Should the facts provided to us be incorrect or incomplete or should the law or its interpretation change, our advice may be inappropriate. We are not responsible for updating our advice for changes in law or interpretation after the date hereof.

- KPMG's advice is for the sole use of KPMG's client. The advice is based on the specific facts and circumstances and the scope of KPMG's engagement and is not intended to be relied upon by any other person. KPMG disclaims any responsibility or liability for any reliance that any person other than the client may place on this advice.

Disclosure Pursuant To Circular 230:

- ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY KPMG TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.