US Estate Planning for Canadians with US Real Property: Life After the Protocol

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Authors' note: After preparation of this article, a revised protocol was released, which has resolved some of the uncertainties noted in the article. We have not altered the original analysis but instead have added several parenthetical notes, in italics, identifying the areas that have been revised.

PRÉCIS

En novembre 1988, les États-Unis ont révisé en profondeur la loi sur l'imposition des biens situés aux États-Unis des successions de personnes décédées non résidantes. Les conséquences de ces révisions étaient extrêmement défavorables pour les résidents canadiens. En outre, aucun allégement n'avait été accordé dans la convention fiscale de 1980 entre le Canada et les États-Unis (la «convention»), et le Canada n'a aucune convention avec les États-Unis relativement aux impôts sur les successions. Les protestations aux modifications ont été immédiates, et de nombreuses personnes ont suggéré que les États-Unis et le Canada négocient un protocole à la convention afin d'alléger les effets négatifs de la nouvelle loi américaine. En août 1994, ce protocole longtemps attendu a été publié, mais il n'a pas encore été ratifié par les deux pays. Lorsque le protocole entrera en vigueur, les dispositions sur l'imposition des biens de personnes décédées, situés aux États-Unis, seront appliquées rétroactivement jusqu'à novembre 1988.

Les auteurs de l'article examinent les dispositions sur l'imposition des successions contenues dans le protocole, en mettant l'accent sur leur incidence sur les résidents canadiens qui ont des biens immeubles aux États-Unis. Bien que le protocole allégera le fardeau de l'impôt américain sur les successions pour de nombreux Canadiens, certaines dispositions

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précises demeurent obscures, et la possibilité demeure que des impôts extrêmement élevés soient exigés des Canadiens dont la succession se compose de biens importants situés aux États-Unis et dans d'autres pays. Par conséquent, il importe de continuer à utiliser les nombreuses techniques de planification successorale visant à réduire ou à éliminer le risque que l'impôt américain sur les successions soit levé sur les biens situés aux États-Unis. Les auteurs suggèrent de détenir les biens incorporels situés aux États-Unis dans une société de portefeuille canadienne. Cependant, il n'existe aucune solution idéale à la propriété de biens immeubles situés aux États-Unis. Les procédés appropriés de planification que doivent utiliser les contribuables détenant ce genre de biens demeurent fonction des faits et des circonstances propres à chaque cas.

ABSTRACT

In November 1988, the United States significantly revised the law regarding taxation of US situs property in the estates of non-resident decedents. For Canadian residents, the result of these revisions was highly unfavourable. Further, no relief was provided in the 1980 Canada-US income tax convention ("the treaty"), and Canada has no estate tax treaty with the United States. Protests to the changes were immediate, and many suggested that the United States and Canada should negotiate a protocol to the treaty to mitigate the negative effects of the new US law. In August 1994, this long-awaited protocol was issued. It has yet to be ratified in both countries. When the protocol comes into effect, the provisions regarding taxation of US situs estates of decedents will be retroactive to November 1988.

The authors of this article examine the estate tax provisions of the protocol, with particular emphasis on the impact they will have on Canadian residents holding US situs real property. Although the protocol will ease the burden of US estate tax for many Canadians, uncertainties exist with respect to specific provisions, and the potential for extremely high taxes remains for Canadians that have significant worldwide estates and US situs property. Consequently, it is important to continue many estate-planning techniques designed to reduce or eliminate exposure to US estate tax on US situs property. The authors suggest that US situs intangibles should be placed in a Canadian holding company. There is, however, no perfect solution for the holding of US situs real property. The appropriate planning procedures for taxpayers holding such property remain a function of the particular facts and circumstances in each case.

INTRODUCTION

On August 31, 1994, the Department of Finance released the long-awaited protocol to the 1980 Canada-US income tax convention.[1] The protocol

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[1] See the protocol signed at Washington, DC on August 31, 1994 (herein referred to as "the protocol"), amending the Convention Between Canada and the United States of America

(The footnote is continued on the next page.)

deals with many issues of concern to Canadian and US taxpayers, including the unfavourable consequences of the current US estate tax rules for Canadian residents who own US situs assets. As a result of the overhauling of those rules in November 1988, the combined impact of US estate taxes and Canadian income taxes arising on death can exceed 90 percent of the value of a Canadian resident's US assets.

The protocol will provide some relief from this potentially confiscatory double tax burden, in particular through the addition of a new article to the treaty—article XXIX B (Taxes Imposed by Reason of Death). Under the provisions of the new article, the level of exemptions and credits available to Canadian residents to offset US estate tax is significantly increased. The protocol will also reduce the effects of exposure to both US estate tax and Canadian income tax on "deemed" capital gains arising on death. However, many Canadians will continue to be subject to substantial US estate tax on the value of their US assets.

In the first part of this article, we summarize the basic rules of the US estate tax, with particular emphasis on issues that may be important to Canadian taxpayers. In the second part, we present a detailed discussion of the provisions contained in the protocol and their apparent implications for Canadian residents. The third part of the article explores the status of "single-purpose" corporations under the protocol. These corporations have been used as a planning tool to remove US real property from the category of "US situs" for US estate tax purposes. Many Canadians may wish to retain these structures, while others may no longer need such tools. Accordingly, we address the requirements for both retaining and unwinding such corporations.

TAXATION ON DEATH

General

Tax jurisdictions may impose three basic types of tax upon the death of an individual. These are inheritance tax, estate tax, and income tax. An inheritance tax is a tax on the receipt of property; an estate tax is a tax on the transfer of property; and an income tax is a tax on the disposition of property through death. Thus, the incidence of tax and the tax base may vary, depending on the nature of the tax imposed. Canada currently has neither an inheritance nor an estate tax, but it does impose an income tax upon the death of an individual. The United States has neither an inheritance nor an income tax, but it does impose an estate tax on the value of property transferred at death. One needs to understand the basics of both of these systems in order to understand the problems created when they overlap.

[1] Continued . . .
with Respect to Taxes on Income and on Capital, signed at Washington on September 26, 1980, as amended by the protocol signed at Ottawa on June 14, 1983 and the protocol signed at Washington on March 28, 1984 (herein referred to as "the treaty").

Canadian Income Tax on Death

General: Deemed Disposition of Property

Subsection 70(5) of the Income Tax Act[2] generally provides that when a taxpayer dies, he or she is deemed to have disposed of all property immediately before his or her death. The proceeds of disposition of the property are equal to the fair market value of the property immediately before death. The heirs to the property are deemed to have acquired the property at a cost equal to the fair market value of the property immediately before the death of the taxpayer.

The executor of the decedent's estate files a tax return for the year of death, reporting the gain or loss from the deemed disposition, as well as any income for the year. The income is taxable according to the normal rules for taxation of individuals. Thus, the executor will claim appropriate deductions and credits on the final return, including any deduction from Canadian income tax for taxes paid to a foreign jurisdiction.

Property Transferred to the Surviving Spouse of the Decedent

ITA subsection 70(6) provides an exception to the general rule of deemed disposition at fair market value where the property is transferred to the decedent's spouse. Under this subsection, the proceeds of disposition are equal to the adjusted cost base of the property immediately before the death of the taxpayer, provided that both the taxpayer and the surviving spouse are Canadian residents at the time of death.[3] The spouse is deemed to have acquired the property at a cost equal to the proceeds of disposition for the decedent taxpayer. The same rules apply if the property is distributed to a spousal trust, under certain conditions.[4]

ITA subsection 70(6.2) permits the executor of the decedent's estate to elect not to apply the above rollover provisions. The result of the election is to treat the dispositions at death as sales at fair market value.

US Estate Tax on Death

The United States imposes a tax on the transfer of the taxable estate of all decedents, whether or not they are citizens or residents of the United States at death.[5] The tax imposed on the estate of a non-resident/non-citizen of the United States (a "non-US person") is primarily a function of the value of the estate that is situated in the United States at death.[6] However,

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[2] Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the ITA").

[3] The rules are different if the property transferred is depreciable. See ITA paragraphs 70(5)(c) and 70(6)(d).

[4] See ITA paragraph 70(6)(b).

[5] Internal Revenue Code of 1986, as amended (herein referred to as "the IRC"), sections 2001(a) and 2101(a).

[6] IRC section 2106(a).

the measurement of the US taxable estate of a non-US person also depends on the measurement of the worldwide estate.[7]

US Estate Tax Base

The US system of taxing wealth transfers combines a tax on the fair market value of taxable gifts made during the taxpayer's lifetime with a tax on the fair market value of assets remaining in the taxpayer's estate at death. For US citizens and residents, the US taxable estate generally is the gross value of the worldwide estate, less various deductions. Available deductions may include a marital deduction for property passing to a surviving spouse; debts of the deceased; testamentary expenses, losses, and taxes paid by the estate; and charitable bequests. The taxable estate for a non-US person is the gross value of the worldwide estate that is situated in the United States, less permitted deductions.[8] There is no marital deduction for property passing to a surviving spouse who is not a US citizen, unless the property is held in a "qualified domestic trust" (QDOT).[9] The deduction for various debts, expenses, and taxes paid by the estate is limited to the total amount of such costs times the ratio of the US situs gross estate to the worldwide gross estate.[10] Consequently, for a non-US person, the value of the worldwide estate affects the computation of the US taxable estate, even though the tax base includes only the US situs assets. The computation of the unified credit available to non-US persons (discussed subsequently) also is sensitive to the value of the worldwide gross estate.

Worldwide Gross Estate

Generally, the worldwide gross estate includes the value "of all property, real or personal, tangible or intangible, wherever situated,"[11] to the extent that the decedent had an interest in the property at the time of death.[12] This is a broad-ranging concept. The gross estate includes not only property held directly by the decedent at death, but also property that was transferred before death in which the decedent possesses a "retained life estate." A retained life estate includes

> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[13]

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[7] See IRC section 2106(a)(1) and the discussion of the unified credit in the second part of this article.

[8] IRC section 2106(a).

[9] IRC sections 2056(d)(1) and (2) and 2056A.

[10] IRC section 2106(a)(1).

[11] IRC section 2031(a).

[12] IRC section 2033.

[13] IRC section 2036(a).

Retention of voting rights in a controlled corporation is considered a retention of the right to enjoy property.[14]

The worldwide estate includes

- the value of annuities,[15]
- the proceeds of life insurance,[16]
- the value of rights of survivorship that may result from pension or other retirement plans,[17]
- any property over which the decedent held a general power of appointment,[18] and
- 100 percent of the value of any joint interest property with right of survivorship or tenants by the entirety (the amount includible can be reduced if the non-decedent person[s] acquired the interest for "adequate and full consideration").[19]

US Situs Property

As noted, for a non-US person, the gross estate includes the above items only if the property was situated in the United States at the time of death of the decedent.[20] However, if the property was transferred with a retained life estate, it is US situs property if it was situated in the United States either at the time of transfer or at the time of death.[21] US situs property includes

- stock issued by a US corporation,[22]
- bonds issued by a US corporation unless the interest payments on the bonds are exempt under IRC section 871(h),[23]
- US treasury bills and other US government securities, and
- real and tangible property located in the United States.

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[14] IRC section 2036(b).

[15] IRC section 2039.

[16] IRC section 2042.

[17] IRC section 2039(a).

[18] IRC section 2041.

[19] IRC section 2040(a). Note that the exclusion for one-half of a joint interest passing to a surviving spouse under IRC section 2040 does not apply if the spouse is not a US citizen. See IRC section 2056(d)(1)(B).

[20] IRC section 2103.

[21] IRC section 2104(b).

[22] IRC section 2104(a). The physical location of the stock certificates is not relevant: see United States, Internal Revenue Service, *Federal Estate and Gift Taxes*, publication 448 (revised August 1992), 26. Questions may arise, however, in the case of Canadian mutual funds holding US stocks. The situs of the interests in such funds depends upon the legal status of the fund itself. Generally, interests in a Canadian mutual fund would be considered Canadian situs property.

[23] IRC sections 2104(c) and 2105(b)(3).

US situs property does not include proceeds from a life insurance policy on a non-US person or deposits in US banks, unless the deposit is connected with a US trade or business.[24] However, cash in a US brokerage account is US situs property.

US Estate Tax Rates

The United States imposes estate tax at progressive rates ranging from 18 percent on taxable estates of $20,000 or less to 55 percent on taxable estates in excess of $3 million. There is a 5 percent clawback of the lower marginal rates for taxable estates between $10 million and $21.04 million. Thus, the marginal tax rate can be as high as 60 percent. As indicated in figure 1, the US estate tax rate rises rapidly, even for relatively small taxable estates, and can result in very high levels of tax.[25]

Credits Against US Estate Tax

US persons receive a basic unified credit against the US estate tax payable equal to $192,800.[26] Non-US persons may receive a unified credit of $13,000 or a pro rata amount based on the $192,800 base amount, depending on whether a tax treaty is applicable.[27] Credits for state death taxes and gift taxes on prior transfers also are available.[28]

NEW ARTICLE XXIX B (TAXES IMPOSED BY REASON OF DEATH)

Background

Currently, the treaty has no provisions regarding US estate and gift taxes. Consequently, for Canadian residents, there is exposure to US estate tax on the value of US situs property as well as exposure to Canadian income tax on gains attributable to US situs property. Under the ITA, there is no deduction from the Canadian income tax payable on death for US estate

[24] IRC section 2105(a) regarding insurance; IRC sections 2104(c) and 2105(b) regarding bank deposits.

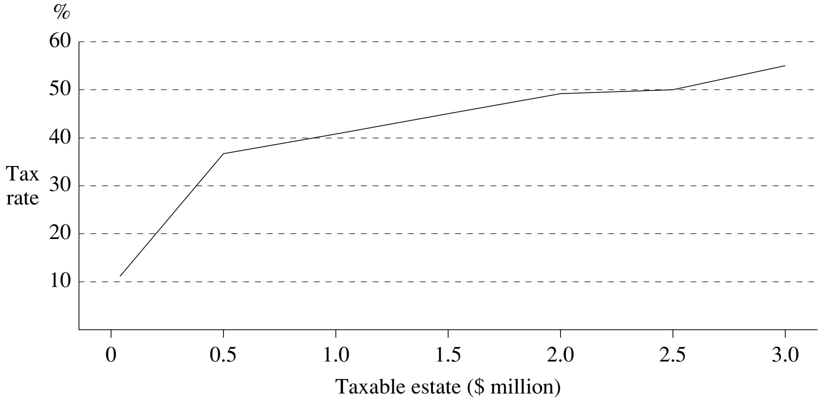
[25] IRC section 2101(b) provides that the tax imposed on estates of non-US persons is the tax imposed under IRC section 2001(c). The US estate tax is the tentative tax, using the rate schedule in IRC section 2001(c), on the total of the taxable estate and the adjusted taxable gifts. This tentative tax is reduced by the amount of gift tax due on taxable lifetime transfers. For a Canadian resident, this amount includes gifts of US situs tangible property greater than the amounts specified in IRC sections 2503(b) and 2523(I) (see infra footnote 57). Note that gifts of US situs intangibles are not taxable gifts for a Canadian citizen and resident as a result of the application of IRC section 2511(b).

[26] IRC section 2010(a). Note that the US estate tax is actually a unified tax on all transfers of wealth by an individual during his or her lifetime and at death. IRC section 2505 provides a credit equal to $192,800 against the tax on taxable lifetime transfers (gifts). These taxable lifetime transfers are included in the tax base for the computation of the total estate tax; thus, the credit is unified as well. To the extent that the credit has been used to reduce US gift tax during the taxpayer's lifetime, it will not reduce the US estate tax due at death.

[27] IRC sections 2102(c)(1) and 2102(c)(3)(A).

[28] IRC sections 2011 through 2016 and 2102(a) and (b).

Figure 1 Current US Estate Tax Rates



tax imposed on these gains because the estate tax is not an income tax; nor does the treaty provide for such a deduction. Similarly, there is no reduction in US estate tax payable in respect of the Canadian income tax incurred on death, although there may be a partial deduction under the rules for computing the value of the US taxable estate.

Before November 1988, this lack coordination between the two systems was not a major concern for most Canadians. The US tax imposed on estates of non-US persons was computed on the basis of a rate schedule and a tax credit that were different from those applicable to US persons.[29] The rate schedule provided for a substantially lower tax than that imposed on US persons, with a correspondingly reduced unified credit. Under this schedule and unified credit, Canadian resident decedents with US situs property paid little or no US estate tax unless the value of the US situs property was greater than US$100,000. Even at levels as high as US$500,000, the effective US estate tax rate was only about 10 percent.

In 1988, the United States changed the system for taxing US situs property held by non-US persons. The United States now imposes tax

[29] IRC section 2101(d), repealed by section 5032(c) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. no. 100-647. Under this rate schedule, US situs taxable estates of non-resident decedents were taxed at 6 percent for amounts not over $100,000. For taxable estates over $100,000 but not over $500,000, the tax was $6,000 plus 12 percent of the excess over $100,000. For estates between $500,000 and $1 million, the tax was $54,000 plus 18 percent of the amount over $500,000. For estates over $1 million but not over $2 million, the tax was $144,000 plus 24 percent of the amount in excess of $1 million. Finally, for estates over $2 million, the tax was $384,000 plus 30 percent of the excess over $2 million.

IRC section 2101 also contained a provision for a unified credit equal to $3,600. This effectively exempted US taxable estates of $60,000 or less. However, note that as a result of this credit and the lower tax rates of the schedule, estates of $100,000 were subject to US estate tax of only $2,400. Estates of $500,000 were subject to tax of $50,400, which is only 10 percent of the value.

based on the rate schedule discussed above, regardless of the citizenship or residency of the decedent.[30] Under this schedule, estates valued at US$100,000 bear an effective tax rate of approximately 26 percent, while estates valued at US$500,000 bear an effective tax rate of approximately 33 percent, before the application of the unified credit.[31] The United States did increase the unified credit available to estates of non-US decedents to US$13,000,[32] and the credit still results in exemption of US situs estates valued at US$60,000 or less. However, it is substantially lower than that available to estates of US decedents.

These changes in the US estate tax system had a dramatic impact on Canadian residents who owned US situs property. As noted earlier, in extreme cases, the total Canadian and US tax imposed could approach 90 percent of the value of the property.[33] Furthermore, relatively small US situs estates were now subject to non-trivial US estate taxes.[34]

The response to these changes was twofold. First, many commentators suggested that the US rules violated certain provisions of the treaty, and/or that the United States and Canada should renegotiate the treaty to provide for an increased unified credit and a deduction against Canadian income tax for US estate tax payable. Second, many Canadian taxpayers increased their efforts to reduce exposure to the US estate tax liability.

The Protocol[35]

Article XXIX B of the protocol addresses both the amount of the unified credit and the availability of a deduction from Canadian income tax on death for US estate tax paid on US situs property. The protocol also provides a credit for property passing to a surviving spouse and exempts worldwide estates valued at less than $1.2 million, under certain conditions. These provisions will improve matters considerably for many Canadian residents. However, several aspects of the protocol are unclear,

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30 IRC section 2101(b) provides that the tax imposed on every decedent non-resident who is not a US citizen is the tax computed under IRC section 2001(c). IRC section 2001(c) is the section that provides the tax rate schedule for the taxable estate of any decedent who is a US citizen or resident.

31 IRC section 2001(c).

32 IRC section 2102(c)(1).

33 Table 3, in the text following, provides various examples of the effective tax rate as a percentage of the gain under various conditions. Referring to the total tax under current provisions, we see that effective tax rates on value also can be quite high. In the case of a US estate of $8 million with an unrealized gain of $1.6 million, the combined US and Canadian tax on value currently is about 58 percent. If the gain on the property were quite high—for example, $7 million—the current effective tax rate as a function of value would be approximately 85 percent.

34 Again, notice in table 3 that, even for a US estate of only $100,000, the current provisions result in effective tax rates of 148 percent of a gain of 10 percent and about 15 percent of the total value.

35 Unless otherwise indicated, for purposes of simplicity, we have assumed throughout this article that Cdn.$1 is equal to US$1.

and the total tax exposure remains high for estates of some Canadian residents that contain US situs property.

Unified Credit

Article XXIX B(2) provides that a resident of Canada at the time of death

> shall be allowed a unified credit in an amount that bears the same ratio to the credit allowed under the law of the United States to the estate of a citizen of the United States as the value of the part of the individual's gross estate that at the time of the individual's death is situated in the United States bears to the value of the individual's entire gross estate wherever situated.

This compares with IRC section 2102(c)(3)(A), which provides:

> To the extent required under any treaty obligation of the United States, the credit allowed under this subsection shall be equal to the amount which bears the same ratio to $192,800 as the value of the part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

Thus, the unified credit for estates of Canadian decedents under the protocol is $192,800 times the value of the US situs gross estate divided by the value of the worldwide estate.[36] One result of this change is that there is no US estate tax liability if the worldwide estate is equal to or less than US $600,000, regardless of the value of the US situs assets or the percentage of their value to the value of the worldwide gross estate.[37]

For most taxpayers, the result of article XXIX B(2) is to increase the amount of US situs property that can be held in an estate without incurring US federal estate tax liability. Table 1 provides examples of the amount of US situs assets that may be held without incurring such tax liability, based on the percentage of the value of US situs assets to the value of the worldwide assets held in the estate, and assuming that the total worldwide estate is greater than $600,000. (Table 1 also contains examples of amounts that may be exempt through the use of the marital credit discussed subsequently.)

Note that the increased credit is a function of both the US and the worldwide gross estate measurements. It is important to remember that the taxpayer must determine these amounts according to US tax provisions. Thus, the worldwide estate includes items outlined previously, such as property transferred with a retained life estate, joint interest property,

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[36] Some commentators have suggested that the protocol provisions regarding calculation of the unified credit are unclear. In our view, it is clear that the intent is to perform the calculations in the manner indicated, when the protocol provisions are read in the context of IRC section 2102(c)(3)(A) and in the context of the method used for calculating the credit for estates in other countries with which the United States has entered into similar estate tax treaty provisions.

[37] Note, however, that the result may be different if the taxpayer has made taxable gifts of US situs property during his or her lifetime. See supra footnotes 25 and 26 and infra footnote 57.

Table 1 US Estate Tax Calculations Applying Article XXIX B(2)

US/WW percentage	Basic credit[a]	Exempt US situs amount[b]	Credit with spousal amount[c]	Exempt US situs amount
6.7427	$ 13,000	$ 60,000	$ 26,000	$ 107,333
10	$ 19,280	$ 83,857	$ 38,560	$ 149,200
20	$ 38,560	$149,200	$ 77,120	$ 268,588
30	$ 57,840	$209,500	$115,680	$ 382,000
40	$ 77,120	$268,588	$154,240	$ 495,412
50	$ 96,400	$325,294	$192,800	$ 600,000
60	$115,680	$382,000	$231,360	$ 704,216
70	$134,960	$438,706	$269,920	$ 805,436
80	$154,240	$495,412	$308,480	$ 904,308
90	$173,520	$547,892	$347,040	$1,003,024
100	$192,800	$600,000	$385,600	$1,097,073

[a] $192,800 × percentage of US situs assets to worldwide assets.

[b] To determine the exempt amount, first determine the marginal tax bracket that the particular credit falls into. Then apply the following formula:

$$\text{Exempt amount} = \frac{\text{credit available} - \text{basic tax for the bracket}}{\text{marginal tax rate for the bracket}} + \begin{array}{c}\text{basic taxable amount}\\ \text{for the bracket.}\end{array}$$

[c] Basic credit × 2.

and so forth. For example, the worldwide estate includes 100 percent of the value of a marital residence or vacation property if the funds for the purchase were provided by the decedent. The property is includible in the gross estate even if it is held as a joint interest with the surviving spouse or if the title to the property is entirely in the name of the surviving spouse. The property is similarly included in the US estate if it is located in the United States.

Table 1 indicates that the protocol is beneficial if US situs assets are equal to or greater than 6.7427 percent of worldwide assets. At that level, the unified credit available under the protocol is equal to the $13,000 unified credit provided in IRC section 2102(c)(1). The protocol is not beneficial, however, for worldwide estates greater than $600,000 that have US situs property that is less than 6.7427 percent of the entire estate. In these cases, it may be preferable for the executor of the estate to choose not to use the treaty, but rather to apply the provisions of the IRC.

It is generally understood that a taxpayer should not be worse off as a result of a tax treaty. In fact, article XXIX(1) of the treaty clearly indicates that a credit or deduction under the IRC should be available to a Canadian resident.[38] However, the technical explanation regarding article XXIX(1), prepared when article XXIX was introduced, indicates that the taxpayer cannot make inconsistent choices between the rules of the IRC and the treaty. It is not clear what constitutes an "inconsistent choice" in

[38] Article XXIX(1) of the treaty provides, "The provisions of this Convention shall not restrict in any manner any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of the tax imposed by that State."

this case. For example, if the executor elects to use the $13,000 credit under the IRC, can the executor also elect to use the marital credit available under article XXIX B(3)?

(Authors' note: The revised protocol provides that the $13,000 unified credit is available under the treaty.)

Marital Credit

Article XXIX B(3) provides an additional credit for transfers to a surviving spouse, stating that a non-refundable credit is allowed "in addition to, but not in excess of, the amount of the unified credit allowed under paragraph 2." No information is provided regarding the actual calculation of this credit; however, it appears that the intent of the provision is to double the basic credit available under article XXIX B(2) for property in the estate passing to the surviving spouse of the decedent.[39] (Presumably, the technical explanation will clarify this point.)

The examples in table 1 show the amount of US situs property that is exempt from US estate tax if the basic credit is doubled. Note that doubling the basic credit does not result in doubling (to $1.2 million) the worldwide estate that is exempt regardless of the percentage of US situs property. On the basis of this calculation technique, a worldwide gross estate of approximately 183 percent of $600,000 is exempt from US taxation, rather than the 200 percent that would be represented by the $1.2 million. This result is attributable to the increased marginal tax rates in effect for amounts over $600,000.

The US taxable amount is highly sensitive to the ratio of US assets to worldwide assets as the worldwide estate increases above $1,097,073. For example, for worldwide estates of $1.2 million, the estate is taxable if US assets exceed 50 percent of the worldwide assets, where all US property passes to the surviving spouse. Similarly, if the worldwide estate is $1.3 million, the estate is taxable if US assets exceed 26 percent of the total; if the worldwide estate is $1.4 million, the estate is taxable if US assets exceed 15 percent, and so forth.

Article XXIX B(3) also provides no information on the calculation of the marital credit if less than 100 percent of the decedent's property passes to the surviving spouse. The marital credit is "in addition to, but not in excess of," the basic credit provided in article XXIX B(2). For example, if the worldwide estate is $2 million and the US estate is $1 million, the US estate tax is $345,800 and the basic credit is $96,400. Thus, the maximum marital credit is $96,400. However, the marital credit

[39] As noted earlier, the United States generally does not permit a marital deduction in computing the taxable estate for property transferred to a surviving spouse who is not a US citizen. The deduction is available, however, if the property is held in a qualified domestic trust. Thus, the intent also may be to eliminate complications caused in establishing a QDOT to defer US estate tax on property passing to a surviving spouse. To qualify for this additional unified credit, the executor must elect not to use the provisions that relate to such trusts (see article XXIX B(3)(d)).

is also limited to the amount of US estate tax that is reasonably attributable to the property passing to the surviving spouse.

Assume that, in this example, $250,000 of the $1 million US property passes to the surviving spouse. This is 25 percent of the total US situs gross estate. Although there may be several possible methods for apportioning the total estate tax to the property passing to the surviving spouse, we understand that the United States is prepared to accept an allocation based on the average rate for the total estate before deducting the unified credit. Using this method, the estate tax attributable to the $250,000 of property passing to the surviving spouse is $86,450. The marital credit is restricted to this amount, which is lower than the pro rata unified credit of $96,400.

(Authors' note: The revised protocol adds a paragraph to article XXIX B providing details regarding the calculation of the marital credit. Under these provisions, the US estate tax allocated to the property passing to the surviving spouse is the amount by which the tax imposed on the estate, including the property passing to the spouse, exceeds the tax that would be imposed if such property were not included in the estate. In the above example, the tax attributable to the $250,000 of property passing to the surviving spouse is $97,500 under these rules. The marital credit is the lesser of the amount attributable to the property passing to the surviving spouse and the pro rata unified credit. Thus, the marital credit in the above example is limited to the basic unified credit of $96,400.)

Generally, it appears that article XXIX B(3) is attempting to alleviate difficulties that arise because the US estate tax provisions do not permit a deduction in computing the taxable estate for property passing to a surviving spouse who is not a US citizen (unless the property is held in a QDOT). Thus, the taxable estate includes the full value of property passing to the surviving spouse; and when the surviving spouse dies, the estate of that spouse also includes the full amount of such property.

IRC section 2056(d)(3) provides some relief from this double inclusion of property in both estates and the consequent double tax burden. It permits a credit for estate tax paid by the estate of the first decedent spouse in computing the estate tax liability for the second decedent spouse, if the estate of the first decedent spouse would have been entitled to a marital deduction for the property but for the fact that the surviving spouse was not a US citizen. This credit is equal to the full amount of estate tax paid by the estate of the first decedent spouse with respect to the US situs property that is subsequently included in the taxable estate of the second decedent spouse, under the provisions of IRC section 2013.[40] Although the amount of the credit is not dependent on the length of time between the death of the first spouse and the death of the surviving spouse, its present value is.

[40] IRC sections 2056(d)(3) and 2013. Note that the amount of the credit is determined without regard to the date of death of the first decedent.

There is no mention of this credit in article XXIX B. Presumably, the intent is that the tax paid by the first decedent with respect to property passing to the surviving spouse is reduced by the amount of the marital credit. This then would correspondingly reduce the amount available as a credit for the estate of the surviving spouse at the time of death of that spouse.

Small Worldwide Estate Exemption

Article XXIX B(7) provides that for estates equal to or less than $1.2 million,

> the United States may impose its estate tax upon property forming part of the estate of the individual only if any gain derived by the individual from the alienation of such property would have been subject to income taxation by the United States in accordance with Article XIII (Gains).

Essentially, therefore, this paragraph exempts estates equal to or less than $1.2 million unless the estate includes property that gives rise to gain that is taxable in the United States. The most common taxable property under article XIII is US situs real property. Article XIII does not permit the United States to tax income generated from stock of a Canadian or US corporation (unless the US corporation holds primarily US real property), and other intangibles.[41]

Article XXIX B(7) does not contain specific rules for the calculation of the estate tax or the unified credit. As a result, it appears that the normal rules of the IRC and the treaty (with protocol) apply for determining the gross and taxable estate, and the estate tax due. The unified credit remains a function of the value of US situs assets, including stocks of US corporations and other intangibles, divided by the value of the worldwide assets. (Presumably, the technical explanation will address this issue.)

This method of calculation may present planning opportunities. Stocks in US corporations and other US situs intangibles are included in both the numerator and the denominator of the fraction for determining the unified credit. Such property is not, however, included in the taxable estate. Consequently, a taxpayer can effectively double the unified credit available by ensuring that US situs intangibles are equal in value to the US situs real property. For example, if the value of the worldwide estate is $1 million and the value of the US situs real property is $200,000, the estate tax payable on the real property is $54,800. After reduction of this tax for a unified credit of $38,560 ($192,800 × 0.2), there is a US estate tax liability of $16,240. If the estate also contains $200,000 in stocks of US corporations or other US situs intangibles, the unified credit increases to $77,120 ($192,800 × 0.4). This reduces the US estate tax liability to zero.[42]

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[41] See infra footnote 82.

[42] One commentator has indicated that the US tax authorities have confirmed this result. See Jack Bernstein, "US Estate Tax Issues" (December 12, 1994), vol. 2, no. 12 *Canadian Tax Highlights* 92-93.

These calculations, however, are sensitive to the measurement of the worldwide gross estate. Assume that the taxpayer holds $600,000 in stocks of US corporations at death. The US estate tax due is zero provided that the gross worldwide estate is $1.2 million or less and there is no other US situs property in the estate. Note that if the gross worldwide estate is increased by $1, to $1,200,001, the US estate tax liability becomes $96,400. Thus, the taxpayer must plan very carefully with respect to the value of the worldwide estate and the property includible in the estate.

Foreign Tax Credit

Article XXIX B(4) provides for a foreign tax credit in Canada equal to the amount of estate tax payable on US situs property. This credit is subject to the calculations and limitations otherwise provided under Canadian domestic law and article XXIV (Elimination of Double Taxation) of the treaty. Thus, to the extent that there is a gain inherent in US situs assets, this gain is included in Canadian taxable income on death (at the appropriate inclusion rate if the gain is capital). The executor then may claim a credit for US estate tax paid up to an amount equal to the Canadian tax on worldwide income times the ratio of US source taxable income to worldwide taxable income, measured under Canadian domestic tax law and treaty article XXIX.[43]

Article XXIX B(4) addresses the problem noted above that the Canadian decedent's estate essentially is taxable twice on the gain inherent in US situs assets, first in the United States and again in Canada. There may, however, be certain basic difficulties in the calculation. The US estate tax is based on the US situs taxable estate.[44] The US taxable estate is the US situs gross estate reduced by various deductions in the proportion that the US situs value bears to the gross estate value.[45] The allowable deductions include the Canadian income tax payable on death.[46] Thus, the US estate tax liability is dependent upon the US taxable estate, which is dependent on the Canadian income tax liability. The Canadian income tax liability, in turn, is dependent on the US estate tax liability.

Essentially, the estate always will pay the greater of the Canadian tax on the gain and the US tax on the value. In most cases, the greater amount will be the US estate tax. The reason is that the US estate tax is a function of the total value of the property, while the Canadian income tax is based only on appreciation on the property. Table 2 provides examples demonstrating that in most cases appreciation on the property would have to exceed 100 percent before there would be Canadian income tax payable in an amount greater than the amount available as a foreign tax credit for

43 See ITA subsection 126(1) and article XXIV of the treaty.

44 IRC section 2101(a).

45 IRC section 2106(a)(1).

46 IRC sections 2106(a)(1) and 2053.

Table 2 Calculation of US Estate Tax Liability at Varying Rates of Appreciation

Worldwide estate	US estate	US tax	Appreciation needed (US tax/0.3975)	Percentage appreciation needed[a]
$1,000,000	$ 20,000	nil[b]	nil	nil
$1,000,000	$ 40,000	nil	nil	nil
$1,000,000	$200,000	$ 16,240	$ 40,855	26%
$3,000,000	$ 60,000	nil	nil	nil
$3,000,000	$120,000	$ 22,088	$ 55,567	86%
$3,000,000	$600,000	$154,240	$388,025	183%
$4,000,000	$ 80,000	$ 14,344	$ 36,086	82%
$4,000,000	$160,000	$ 34,288	$ 86,259	117%
$5,000,000	$100,000	$ 19,944	$ 50,174	101%

Note: Provided that the US tax on *value* is greater than or equal to the Canadian income tax on *gain*, the foreign tax credit mechanism will eliminate the Canadian income tax (subject to the comments in footnote 47). If the asset gives rise to capital gain, 75 percent of the gain is taxable. At a combined federal and provincial tax rate of 53 percent, the Canadian income tax on gain is equal to 39.75 percent. Thus, if the US tax on value is greater than or equal to 39.75 percent of any gain, the US estate tax will eliminate the Canadian income tax. This is likely to be the case except when (1) the value of the US estate is low enough that there is no US estate tax (in which case there is no circular problem), (2) both US and worldwide estate values are low, or (3) appreciation rates are extremely high.

[a] US estate − appreciation needed = cost amount. Appreciation/cost = percentage appreciation needed. [b] Assuming that the executor of the estate elects to use the $13,000 unified credit provided under the IRC, rather than the provisions of the treaty.

the US estate tax payable.[47] However, if the Canadian income tax on the gain is greater than the US estate tax, the Canadian tax may be deducted from the US gross estate, on the basis of the ratio of the US estate to the worldwide estate.

There also may be difficulties related to the tax treatment of US situs intangibles. For US estate tax purposes, the value of these intangibles is included in the US taxable estate of the decedent (unless the estate qualifies for the small estate exemption discussed above). Thus, there may be a US estate tax liability resulting from the holding of such assets if the value of the worldwide estate exceeds $1.2 million.

Article XXIX B(5) provides for a foreign tax credit in Canada for US estate tax only if the gain on the property is US source within the meaning of article XXIV(3). Under article XXIV(3), gains on intangibles are

[47] We have assumed that the US estate tax will offset the Canadian income tax on US source gains provided that the estate tax is at least equal to the Canadian income tax attributable to such gains. This may not be strictly true. We have assumed that the US gain is taxed at the maximum marginal tax rate for the individual. The foreign tax credit limit mechanism essentially provides for a credit based on the average tax rate of the individual. To the extent that the individual has substantial income, these two rates may converge. However, to the extent that the marginal and average rates are different, there will be some discrepancies.

not US source because they are not taxable under the provisions of article XIII(5). Consequently, there is no foreign tax credit available in Canada for the US estate tax payable because these gains are not included in the numerator for purposes of calculating the foreign tax credit limitation. We understand that this is an error and will be adjusted for situations where the value of the US situs intangibles is subject to US estate tax.[48]

(Authors' note: The revised protocol alters the foreign tax credit provisions to ensure that the foreign tax credit is available to offset Canadian income tax on gains on US situs property, including the gains on such intangibles.)

The foreign tax credit provisions also may not be particularly helpful in the case of transfers to a surviving spouse. As noted, ITA subsection 70(6) provides that property transferred to the surviving spouse is disposed of for proceeds equal to the adjusted cost base of the property. Consequently, there generally is no Canadian income tax payable on the transfer. This may present problems when there is a US estate tax liability on such property in excess of the basic and marital credits provided under article XXIX B. In these circumstances, it may be advisable for the executor of the estate to elect under ITA subsection 70(6.2) not to apply the provisions of subsection 70(6).[49]

(Authors' note: The revised protocol does not address this issue. Depending on the taxpayer's particular circumstances, it may still be advisable to elect not to apply the provisions of subsection 70(6).)

US State Estate Taxes

It is unclear under the protocol whether state estate taxes are available as a credit against Canadian income tax payable on death. Article XXIX B(5) provides that

> the amount of *any* estate tax payable in the United States in respect of the individual's property situated in the United States shall be allowed as a deduction from the amount of any tax otherwise payable in Canada [emphasis added].

However, new paragraph 2(b)(iv) of article II (Taxes Covered) provides that taxes covered under the treaty include

> [t]he United States estate taxes imposed by the Internal Revenue Code of 1986, to the extent, and only to the extent, necessary to implement the provisions of Article XXIX B (Taxes Imposed by Reason of Death).

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48 Note, however, that it is relatively easy to remove such intangibles from the US estate tax base by placing them in a Canadian holding company. This procedure does not involve any of the potential pitfalls encountered with personal-use assets. Furthermore, Canadian tax provisions regarding Canadian-controlled private corporations generally ensure that the use of such a holding company does not result in significant double taxation in Canada, inter vivos or on death. The taxpayer does, however, incur costs associated with maintaining the corporation. Difficulties may be encountered if the Canadian resident holds options on US corporate stocks at death. The value of such options is includible in the worldwide gross estate. It also appears that such options are US situs property.

49 There may be similar problems with spousal rollover trusts.

Thus, while article XXIX B implies that the state estate tax would be available as a credit, the above provision appears to indicate that such taxes will not be available as a credit.[50]

This issue is a concern only when the Canadian income tax on US source gains is greater than the US federal estate tax on death. Generally, if the estate is taxable at the federal level in the United States, this result is unlikely, for the reasons discussed above. However, the issue does arise in circumstances where there is no US federal estate tax imposed, but there is a US state estate tax imposed.

As a general rule, many states (including Florida, Arizona, California, and Hawaii) do not impose estate tax if there is no federal estate tax. However, this is not the case universally. New York, for example, calculates the estate tax essentially by first assuming that the decedent is a resident of New York. A preliminary estate tax is computed on the basis of the value of the gross worldwide estate. The New York tax liability is this preliminary tax multiplied by the ratio of the New York situs property to the worldwide estate. Thus, a taxpayer with a New York situs estate of $60,000 could be subject to estate tax in New York, even though the taxpayer would not be subject to US federal estate tax.

(Authors' note: The revised protocol clarifies that state estate taxes are available for the foreign tax credit in Canada.)

Effective Dates

Article 21 of the protocol provides that the protocol shall enter into force upon the exchange of instruments of ratification. Article 21(4), however, provides that article XXIX B and other provisions related to this article

> shall, notwithstanding any limitation imposed under the law of a Contracting State on the assessment, reassessment or refund with respect to a person's return, have effect with respect to deaths occurring after the date on which the protocol enters into force and, provided that any claim for refund by reason of this sentence is filed within one year of the date on which the protocol enters into force or within the otherwise applicable period for filing such claims under domestic law, with respect to benefits provided under any of those paragraphs with respect to deaths occurring after November 10, 1988.

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[50] Under the treaty currently, article II(2)(b) provides that the treaty covers only federal income taxes imposed by the IRC. However, article XXIV(7) provides that "income tax paid or accrued" includes taxes imposed by a political subdivision or local authority "which are substantially similar to the taxes of that State referred to in paragraphs 2 and 3(a) of Article II (Taxes Covered)."

The protocol modifies this paragraph by removing the reference to article II. The new paragraph 7 will read "and which are substantially similar to the Canadian tax or United States tax, as the case may be." In either case, the paragraph refers only to income taxes. Thus, on the one hand, it is clear that generally the treaty provisions cover federal and subfederal level taxes on income, notwithstanding the limitation provided in article II(2) to federal taxes only. On the other hand, the negotiators had the opportunity to refer to subfederal estate taxes in the amendments to article XXIV(7) and did not. Thus, it remains unclear whether the intent is to permit a credit for subfederal estate taxes.

Consequently, the executors and/or heirs of estates of decedents who died after November 10, 1988 should review any tax filings made with respect to US situs property held by the decedent at death. The responsible individuals should begin gathering necessary documentation to file a claim for a refund under the provisions of the protocol, if such a refund is in order.

Compliance

The executor of the estate of a Canadian resident must file a US federal estate tax return if the part of the gross estate that is situated in the United States exceeds $60,000.[51] This is equal to the amount exempted by IRC section 2102(c), without the benefits of a treaty. It is clear that to obtain the benefits of the unified credit provided under article XXIX B(2), the executor must file a US estate tax return because

> [t]he credit otherwise allowable under this paragraph shall be allowed only if all information necessary for the verification and computation of the credit is provided.

Presumably, it is also necessary to file an estate tax return in order to obtain the benefits regarding the spousal credit, inasmuch as that credit is dependent upon the credit in article XXIX B(2). (And, of course, the executor must file an appropriate election to obtain the benefits of the spousal credit in any case.)

It is not clear whether an estate tax return must be filed in order to obtain the benefits of article XXIX B(7), referring to the exemption of worldwide estates less than $1.2 million. If such estates contain US situs non-real property, they are not taxable under the protocol. However, if such property has a value greater than $60,000, it appears that an estate tax return remains necessary, under current filing requirements. In any case, it seems clear that a "treaty-based" information return is required in order to obtain the benefits of any of the provisions of article XXIX B.[52] Thus, executors of estates with US situs assets greater than $60,000 generally must file a US estate tax return and a treaty-based information

51 IRC section 6018(a)(2).

52 IRC section 6114(a) requires that each taxpayer who, "with respect to any tax imposed by this title, takes the position that a treaty of the United States overrules (or otherwise modifies) an internal revenue law of the United States shall disclose . . . such position." The IRC is title 26 of the United States Code, and the estate tax is subtitle B of this title. Accordingly, IRC section 6114 does apply to estate tax matters. It may be arguable that the use of article XXIX B(2) to increase the unified credit is authorized by IRC section 2102(c)(3)(A) and consequently does not require treaty-based disclosures. IRC reg. section 301.6114(c)(1), however, provides a list of exceptions to the requirement for treaty-based disclosures, and this list does not include issues related to estate tax matters. In any case, since the executor must file an estate tax return in order to obtain the increased unified credit, attaching the additional information should be no great burden. In other cases, it appears that the requirements of IRC section 6114 do apply to the use of article XXIX B.

return. Executors of estates eligible for exemption under article XXIX B(7) may be required to file only the treaty-based information return.[53]

Issues may arise regarding compliance with US estate tax requirements for estates of decedents who die before the ratification date of the protocol. If ratification is delayed (as a result of the changes in Congress), the estate tax return may become due before the date of ratification. We suggest that, in such cases, the executor file the appropriate returns but pay tax equal to the amount that will be due under the protocol. The executor should attach a statement to the return requesting that the Internal Revenue Service (IRS) review the return in the context of the protocol provisions.

Note that the protocol also adds new article XXVI A (Assistance in Collection) to the treaty. Under this article, Canadian tax authorities may assist the IRS in collecting a revenue claim for US estate tax liabilities.

Summary

The provisions of the protocol will reduce the effect of US estate tax on Canadian taxpayers. For many taxpayers with relatively small worldwide estates, the US estate tax is eliminated or significantly lower than the tax under current rules. As indicated in table 3, however, the total tax payable on US situs property held by Canadian residents at death generally remains higher than the tax imposed under Canadian tax provisions. Thus, considerable advantages can be gained by careful estate tax planning.

US ESTATE TAX PLANNING AND THE SINGLE-PURPOSE CORPORATION

Estate Tax Planning: General

Techniques that may reduce the exposure to US and worldwide tax liability on death include

- reducing the worldwide estate,
- reducing the US situs assets, and
- increasing the deductions available to the estate.

Planning to reduce the worldwide estate has had a relatively minor impact on the US estate tax liability in the past. As noted, a Canadian taxpayer may deduct claims against the estate in the ratio of the US estate to the worldwide estate. Thus, reducing the worldwide estate may increase the deduction for claims against the estate. Unless the claims against the estate are significant as compared with the value, however, this generally does not have a major impact on the US estate tax liability.

[53] Under certain circumstances, it may be wise to consider filing a nil estate tax return even when not required. In some states, a tax clearance is a prerequisite to obtaining title clearance on the sale of real property. The taxpayer should investigate the title clearance provisions in US jurisdictions where the real (or intangible) property is located in order to determine the procedures to be completed upon a sale of the property. Note that this should not be a problem if the property is held by a Canadian corporation, because the title to the property does not change hands upon the death of the decedent.

Table 3 Comparison of Tax Liability on Death Under Current Rules and Under the Protocol

Value of worldwide estate	Value of US estate	Assumed gain	Tax under current rules			Effective tax % on gain[b]	Tax under protocol			Effective tax % on gain[b]
			US tax[a]	Cdn. tax	Total		US tax[a]	Cdn. tax[c]	Total	
$ 1,000,000	$ 100,000	$ 10,000	$ 10,800	$ 3,975	$ 14,775	148%	$ 4,520	nil	$ 4,520	45%
$ 2,000,000	$ 200,000	$ 20,000	$ 41,800	$ 7,950	$ 49,750	249%	$ 35,520	nil	$ 35,520	178%
$ 5,000,000	$ 500,000	$ 50,000	$ 142,800	$ 19,875	$ 162,675	325%	$ 136,520	nil	$ 136,520	273%
$10,000,000	$1,000,000	$ 100,000	$ 332,800	$ 39,750	$ 372,550	373%	$ 326,520	nil	$ 326,520	327%
$ 1,000,000	$ 800,000	$ 160,000	$ 254,800	$ 63,600	$ 318,400	199%	$ 113,560	nil	$ 113,560	71%
$ 2,000,000	$1,600,000	$ 320,000	$ 587,800	$127,200	$ 715,000	223%	$ 446,560	nil	$ 446,560	140%
$ 5,000,000	$4,000,000	$ 800,000	$1,827,800	$318,000	$2,145,800	268%	$1,686,560	nil	$1,686,560	211%
$10,000,000	$8,000,000	$1,600,000	$4,027,800	$636,000	$4,663,800	291%	$3,886,560	nil	$3,886,560	243%

[a] The tax under the current rules is equal to the total US tax less the unified credit of $13,000. The tax under the protocol is equal to the total US tax less the unified credit times the proportion of the US to the worldwide estate. Under the above calculations, when the US estate is equal to 10 percent of the worldwide estate, this results in a US estate tax saving of $6,280 under the protocol as compared with the current rules. When the US estate is equal to 80 percent of the worldwide estate, the result is a US tax saving of $141,240 under the protocol as compared with the current rules. The total tax saving under the protocol will be equal to the US tax saving, plus the Canadian income tax no longer payable. [b] The effective rate on the gain will be equal to only the Canadian effective rate of 39.75 percent if the property is not US situs. Thus, even after the application of the protocol and the foreign tax credit, the taxpayer has considerable incentive to remove assets from US situs status. [c] If the US estate tax under the protocol is greater than or equal to the Canadian tax under the current rules, there should be no Canadian tax on the income after application of the foreign tax credit rules under the protocol. However, see the comments in footnote 47.

Under the protocol, planning to reduce the worldwide estate may have a more significant impact on the US tax consequences. The amount of claims deductible against the taxable estate remains sensitive to the proportional values of the US to the worldwide estate. However, the level of the unified credit also is sensitive to the proportional values of the US to the worldwide estate, as demonstrated in table 1. The increased importance of the worldwide estate itself alters certain aspects of US estate tax planning for Canadians.

For example, insurance is commonly recommended as a method of providing funds to finance the US estate tax liability and Canadian income tax arising on death. US situs property does not include insurance proceeds payable to the estate on the death of a non-US person.[54] Thus, insurance can provide the funds for the tax without being included in the US tax base. Such insurance proceeds are, however, part of the worldwide gross estate.[55] Consequently, the insurance proceeds may reduce the unified credit available because they increase the worldwide estate, thereby decreasing the ratio. Nevertheless, insurance remains an effective technique if it is properly structured.[56] Furthermore, the impact on the ratio may be relatively small, depending on the total size of the worldwide estate.

Other planning alternatives may include use of non-recourse debt to fund US real property assets, planning a pattern of gifting inter vivos,[57] making charitable bequests, and so forth. In particular, taxpayers may obtain significant benefits from planning to remove assets from classification as US situs property. For example, it is common to hold US situs intangibles, such as stocks in a US corporation, in a Canadian holding company.

It also is common for taxpayers worldwide to use a similar technique for holding US situs real property. By holding these assets in a foreign corporation, the taxpayer removes them from the US estate tax net. The

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54 IRC section 2105(a).

55 IRC section 2042. Insurance proceeds are part of the worldwide gross estate if the proceeds are payable to the estate or if the decedent retains any incidents of ownership in the insurance, including a reversionary interest if the value of such interest exceeds 5 percent of the value of the policy immediately before the death of the decedent. A reversionary interest includes a possibility that the policy or the proceeds may return to the decedent or his estate, or be subject to a power of disposition by the decedent.

56 For example, it may be necessary to create an irrevocable trust to hold the policy, with limited control by the decedent during his or her lifetime. Generally, this is standard practice for estate planning in the United States.

57 A plan of gifting must be carefully structured. For Canadian tax purposes, inter vivos transfers may result in a deemed sale at fair market value. For US tax purposes, a gift tax may be imposed on the transfer unless the amounts are less than the exempt amounts provided in the estate and gift tax provisions of the IRC. The individual may gift intangibles without US gift tax implications. Gifts of other property are exempt up to US$10,000 per year if they are made to a person other than a spouse (IRC section 2503(b)). Gifts of other property to a non-US citizen spouse may be exempt up to US$100,000 per year (IRC section 2523(I)).

shares of the foreign corporation are not US situs property, even though the corporation owns US real property.

This particular planning alternative, however, creates problems for Canadian taxpayers. Canadian domestic law provides that

> [w]here at any time in a taxation year a benefit is conferred on a shareholder . . . by a corporation . . . the amount or value thereof shall . . . be included in computing the income of the shareholder for the year.[58]

Therefore, if this rule were applied, planning to remove a US vacation home from its status as US situs property would carry a price tag equal to the Canadian income tax due on the value of the benefit attributable to the personal use of the residence.

Single-Purpose Corporations

Background

In 1980,[59] Revenue Canada confirmed that a taxable benefit results when the fair market value attributable to the personal use of corporate property by a shareholder is greater than the amounts paid by the shareholder to the corporation. However, the department indicated that, under certain conditions, it would not assess benefits for a shareholder's personal use of a US residence. These conditions came to be known as the single-purpose corporation rules, because the first condition is that "[t]he corporation's only objective is the holding of property for the personal use or enjoyment of the shareholder."[60]

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[58] ITA subsection 15(1).

[59] "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 606-7.

[60] Revenue Canada generally considers the benefit to be equal to the fair rental value of the property, or an amount that results in a normal rate of return on the greater of the cost and the fair market value of the property, plus costs incurred by the corporation. See "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988), 47:1-103, question 33, at 47:23. The shareholder benefit inclusion can be quite high. For example, at a prescribed rate of 8 percent, the shareholder benefit inclusion on a vacation property costing $250,000 would be $20,000, resulting in a Canadian tax liability of about $10,000 for each year of shareholder benefit inclusion. The shareholder benefit inclusion may be higher than $20,000 if the long-term fair market lease rate on the property exceeds $1,667 per month ($20,000/12). In addition, there may be double taxation on any appreciation on the property as a result of holding the property through a corporation. Appreciation on the property held by the corporation will increase the value of the stock in the corporation. At death, this increase in stock value is included in the decedent's Canadian income tax return, resulting in Canadian income tax payable on the appreciation on the property. However, there is no increase in basis in the hands of the corporation. Consequently, when the property is distributed or sold, the appreciation on the property is also taxable to the corporation in the United States.

On the other hand, it may be possible to restructure the corporation using debt so that the facts follow the situation in *Youngman v. The Queen*, 90 DTC 6322; [1990] 2 CTC 10

(The footnote is continued on the next page.)

In 1988, as noted earlier, the United States changed its domestic tax statute in a manner that significantly increased the exposure to US estate tax for Canadian residents holding US situs assets. Taxpayers holding US vacation homes were particularly at risk, and interest in single-purpose corporations increased dramatically. The provisions of the protocol will reduce US estate tax exposure for Canadians holding US vacation property. Thus, Canadian residents should review their worldwide and US situs property to determine their potential exposure under the protocol provisions.

For some Canadian taxpayers, the provisions of the protocol may eliminate the need for elaborate planning regarding US situs property. For others, there may still be considerable benefits from holding US situs real property through a Canadian corporation. There is no Canadian income tax cost to such corporations, provided that the corporation meets the criteria for qualification as a single-purpose corporation (summarized below). Note that the benefit of holding non-US situs property is greater than simply avoiding US estate tax. Elimination of US situs property from an estate of a non-US person also eliminates US estate tax compliance requirements.[61]

Canadian Provisions

The following summary lists the various conditions to be met for qualification as a single-purpose corporation in Canada. Taxpayers who hold US situs property in a qualifying single-purpose corporation should review these conditions regularly to ensure that the corporation remains qualified.

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60 Continued . . .
(FCA). Thus, it might be argued that no shareholder benefit exists if the shareholder provides a non-interest-bearing loan to the corporation to acquire the property, and the corporation charges rent equal to the expenses incurred. The shareholder also could consider renting the vacation property for part of the year in order to generate income. However, in this case, the US tax consequences will be substantially different from those discussed herein. Thus, taxpayers must consider their exposure under the single-purpose corporation and shareholder benefit provisions and evaluate the tradeoff between corporate ownership and potential US estate tax liability on the property.

61 The cost of complying with US estate tax filing requirements is non-trivial for many taxpayers. Even if the taxpayer is exempt from US estate tax or is taxable at a low level, the taxpayer must provide information on the amount and value of the worldwide estate as well as the US situs estate in order to obtain the benefits of this exemption or lower-level tax. These determinations must be made by applying the provisions of the US statute outlined in the first part of this article. Furthermore, the necessary valuations may be difficult to obtain or may be subject to risk of challenge by the US tax authorities. On the other hand, some tax compliance may be necessary in order to obtain a tax clearance for purposes of transferring title to assets located in the United States.

Single-Purpose Corporation Qualification Criteria[62]

1) The corporation's only objective is the holding of property for the personal use or enjoyment of the shareholder(s).

a) Use of the property by persons other than the shareholder(s) may violate this requirement.[63]

b) The corporation may not rent property or sign a lease with anyone, including the shareholder(s).[64]

2) The shares of the corporation are held by an individual or by an individual and persons (other than a corporation) related to the individual.

a) Shares may not be held by a trust.[65]

3) All transactions of the corporation relate to its objective of holding property for the personal use or enjoyment of the shareholder(s).

a) Preferred stock appears to be prohibited.[66]

b) The corporation may not hold more than one property,[67] and the shareholder(s) may not hold shares in more than one single-purpose corporation.[68]

c) The corporation no longer qualifies as single purpose once the residential property is sold.[69]

4) The shareholder(s) will be charged with all the operating expenses of the property by the corporation, so that the corporation will show no profit or loss with respect to the property on any of its income tax returns.

a) The shareholder(s) may not pay rent equal to these expenses.[70]

b) It appears that all shareholders must bear a pro rata share of the expenses;[71] it is unclear whether failure to do so results in disqualification of the corporation itself or in shareholder benefits received by the individual shareholders.

c) The corporation may establish bank accounts and make payments; bank accounts must not be interest-bearing.[72]

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[62] The first four criteria in this summary are taken from question 20 of the 1980 "Revenue Canada Round Table," supra footnote 59.

[63] Technical interpretation of the Business and General Division, January 22, 1991.

[64] "Revenue Canada Round Table," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 45:1-60, question 9, at 45:5.

[65] Technical interpretation of the Reorganizations and Non-Resident Division, August 31, 1990.

[66] Ibid.

[67] Technical interpretation of the Business and General Division, August 27, 1990.

[68] Ibid.

[69] Technical interpretation of the Reorganizations and Non-Resident Division, May 10, 1991.

[70] See supra footnote 64.

[71] See supra footnote 65.

[72] Private conversation with an official of Specialty Rulings, February 15, 1994.

d) The corporation must file Canadian federal and provincial income tax returns as appropriate; it may be subject to provincial capital taxes.[73]

5) The corporation must have acquired the property with funds provided by the shareholder(s) and not by virtue of the holdings of the shareholder(s) or those of a related person in any other corporation.[74]

a) A parent may not lend to a corporation owned by his or her children.[75]

b) An interest-free intercorporate loan is not permitted.[76]

c) Qualification for this purpose is on a shareholder-by-shareholder basis.[77]

d) It does not matter where the shareholder(s) obtained funds, as long as they were not obtained through an undue tax benefit.[78]

e) The corporation will not qualify as a single-purpose corporation after the death of the original shareholder(s) because the subsequent shareholder(s) did not provide funds.[79]

f) The corporation is permitted to obtain a mortgage from an arm's-length lender.[80]

6) The property must be acquired by the corporation on a fully taxable basis—that is, without the use of any of the rollover provisions in the Act.

a) ITA section 85 is considered inapplicable.[81]

A qualifying single-purpose corporation should file a T2, "Corporate Income Tax Return," in Canada each year and any appropriate provincial tax returns, including capital tax returns. All tax returns should show nil income, deductions, profit, and loss. The corporation should have and maintain its own bank account, as well as corporate books and records. This account should be non-interest-bearing, so as to avoid violation of the single-purpose qualification provisions. All relevant invoices for costs associated with holding the real property should be received in the

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[73] Ibid. Note that Specialty Rulings indicated that it does not matter what the taxpayer does on US tax filings.

[74] "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 49:1-32, question 14, at 49:8.

[75] See supra footnote 65.

[76] "Revenue Canada Round Table," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 53:1-188, question 2, at 53:32.

[77] See supra footnote 65.

[78] See supra footnote 67.

[79] Confirmed in private conversation with an official of Specialty Rulings, February 15, 1994.

[80] Technical interpretation of the Reorganizations and Non-Resident Division, July 17, 1989.

[81] Technical interpretation of the Reorganizations and Non-Resident Division, June 14, 1990; and question 9 of the 1989 "Revenue Canada Round Table," supra footnote 64.

corporate name and paid through the corporate account. Of course, the shareholder(s) must reimburse the corporation on a regular basis for all costs incurred.

US Provisions[82]

It has been suggested that the IRS will look through the legal ownership by the single-purpose corporation and treat the US vacation property as US situs property in the estate of the decedent shareholder.[83] The IRS has issued similar challenges in the past but has had minimal success in piercing the corporate veil. It is interesting to note in this context that Congress has acknowledged that a foreign taxpayer may remove assets from US situs for estate tax purposes through the use of a foreign corporation.[84] Congress has not, however, enacted statutory rules to prevent the use of such structures for estate-planning purposes.[85]

The shareholder(s) should ensure that the corporation is operated as a separate entity and complies with the necessary provisions in the US jurisdiction where the real property is located. Thus, the shareholder(s) should ensure that the corporation is registered in the appropriate US jurisdiction, if required. The corporation should complete all appropriate

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[82] For purposes of the discussion of the US tax treatment of a single-purpose corporation, we are assuming that the corporation does not have a valid IRC section 897(i) election in place. Under this election, the corporation would be treated as a US corporation, and thus, the Canadian corporation would be a "US real property holding corporation" and the stock in the corporation would constitute a "US real property interest." The US tax consequences for the Canadian corporation and the shareholders are substantially different from those that result without an IRC section 897(i) election in place. We think it is reasonable to assume that there is no valid election under this section because the corporation must be eligible for non-discrimination treatment under the treaty in order to qualify for the election. For a Canadian corporation to be eligible for non-discrimination treatment under the treaty, it must have a permanent establishment in the United States (article XXV(6)). Article V(1) of the treaty provides that a permanent establishment is an office or fixed place of business through which the business is carried on. Since the Canadian corporation is not permitted to carry on business, it cannot have a place of business and therefore cannot have a permanent establishment. Without a permanent establishment, it is not eligible for non-discrimination protection under the treaty and therefore also is not eligible to make the election provided in IRC section 897(i). Canadian taxpayers who filed an IRC section 897(i) election should review the status of their corporation. It is possible that the corporation has engaged in activities that would result in disqualification as single purpose or that the IRC section 897(i) election is invalid.

[83] Bruce N. Lemons, Thomas H. Olson, and L. Alan Rautenberg, "Single-Purpose Corporations May Not Avoid US Estate Tax" (1991), vol. 39, no. 4 *Canadian Tax Journal* 835-47.

[84] S. 1707, 89th Cong., 2d sess., 54 (1966), 1966-2 CB 1059, at 1097. This issue is discussed in detail in Monte A. Jackel, "Taxing U.S. Assets Held by a Foreign Holding Company—The Return of Swan and Fillman" (June 8, 1990), 19 *Tax Management International Journal* 263-67.

[85] The restrictive nature of the single-purpose corporation qualifications may provide the IRS with a strong "facts and circumstances" case to challenge the validity of such corporations. However, to date the IRS apparently has not attempted to assess on this basis. It is questionable whether the benefits of attempting to do so would outweigh the costs.

tax and other filings on a timely basis. There may be some costs attached to achieving this goal. In Florida, for example, the corporation must maintain a registered office and a registered agent as long as the corporation holds Florida real property.[86] In addition, real, tangible, and intangible personal property tax returns may be required in the particular jurisdiction.

It is, however, unlikely that the corporation will need to file US federal or subfederal income tax returns. For Canadian purposes, the corporation cannot sign a lease or receive rental income. As a result, the corporation generates no income and has no deductible expenses.[87] Under these conditions, there is no US income tax liability and no reporting requirements.[88]

Some practitioners have suggested that the IRS may attempt to impute rental income to the shareholder equal to the fair market value of the personal use by the shareholder of the US property. However, rather than impute rental income to the corporation as a result of the personal use of corporate property by a shareholder, the US courts generally have treated the value of such use as a distribution by the corporation to the shareholder, usually resulting in a taxable dividend in the hands of the

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[86] Section 607.0505 of the Florida Business Corporations Act. Florida also may impose a sales and use tax on persons using real property that is not owned by them. Other states have varying tax provisions regarding registration, property taxes, and sales and use taxes which should be investigated.

[87] IRC section 63 does require that the payment of a lessor's expenses by a lessee be included in the rental income of the lessor (assuming that the payments are required under the lease). However, if there is no lease, there appears to be no basis in law for the IRS to treat the payment of corporate expenses by the shareholder as rental income to the corporation. Since a single-purpose corporation cannot enter into a lease and retain its status, IRC section 63 should not apply to impute rental income. Note that if the corporation has entered into a lease with the shareholder(s), it may be advisable to unwind the corporation in any case, because it may not qualify for single-purpose corporation status in Canada.

[88] IRC reg. section 1.6012-2(g)(2) provides that a foreign corporation that does not engage in a US trade or business is not required to file a US tax return, provided that any US tax liability for the year is satisfied by source withholding. It appears clear that a single-purpose corporation cannot be considered to be carrying on a business, and the US courts have ruled that the fact that property is held by a corporation does not automatically mean that the property is used in a trade or business (*Graves Brothers Co.*, 17 TC 1499 (1952)). The only source withholding that might arguably be required would be withholding on deemed rental income paid to a foreign corporation. However, as discussed in this article, we do not believe that the IRS would be successful in imputing rental income to the corporation, so that there also would be no US tax liability resulting from a withholding at source requirement.

If the corporation already has begun filing US income tax returns, it may be advisable for it to continue doing so. If the corporation ceases to file such returns, the IRS computers are likely to request the return or a reason for non-filing. In this case, it may be preferable to file nil returns each year until the corporation is liquidated, at which point a final return can be filed. Alternatively, the corporation could cease filing tax returns and respond to a request for a return from the IRS by indicating that the corporation does not have any US source income, is not engaged in a US trade or business, and therefore has no filing responsibilities as noted above.

shareholder.[89] In *Spark's Farm*,[90] the IRS attempted to impute income to the corporation for the personal use by the shareholder of the farmhouse owned by the corporation. The court stated:

> The corporation is being charged for rental income it did not receive. This is not a proper allocation . . . as permitted under section 482, but an unwarranted attempt to create taxable income out of nothing. We conclude that the corporation's income should not be increased by these amounts of non-existent rental income.[91]

The payment of the expenses of holding the real property also is unlikely to represent rent to the corporation. Generally, US courts have ruled that the payment of corporate expenses by the shareholder represents a contribution to the capital of the corporation.[92] IRC section 118 provides that contributions to the capital of a corporation by shareholders do not constitute gross income to the corporation. Furthermore, the corporation would not be permitted any deductions related to holding the property, because the use of the property must be solely for the benefit of the shareholder(s). The IRS and the US courts have held that a corporation can receive no business deduction for expenses related to stockholder use of corporate assets for personal purposes.[93]

Thus, it appears unlikely, on the basis of this analysis, that a single-purpose corporation will have income or deductions for US tax purposes.[94] Rather, for US purposes, the value of the benefit that a shareholder obtains from personal use of corporate property is deemed to be a

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[89] See the analysis provided in Nathan Boidman and Jeffrey D. Scheine, "Corporate Ownership of United States Homes—Imputed Income or Benefit?" (April 14, 1989), 18 *Tax Management International Journal* 180-85; *Johnson et al. v. US*, 70-1 USTC paragraph 9432 (Dist. Ct.); *Offshore Operations Tr.*, 32 TCM 985 (1973); *Security Associates Agency Insurance Corp.*, 53 TCM 1239 (1987); *J. Henry Holland, Jr.*, 33 TCM 611 (1974); *Gardner et al. v. Comr.*, 80-1 USTC paragraph 9179 (6th Cir.), aff'g. 35 TCM 1592 (1976); *Daniel T. Galluzzo*, 43 TCM 199 (1981); *Weber Electric, Inc.*, 52 TCM 62 (1986); *Brown v. US*, 73-2 USTC paragraph 9744 (Dist. Ct.); and *Crosby et al. v. US*, 74-2 USTC paragraph 9550 (5th Cir.).

[90] *Spark's Farm, Inc.*, 56 TCM 464 (1988).

[91] Ibid., at 479.

[92] See *Marcus Conant*, 52 TCM 377 (1986); and *John Van Hassent*, 60 TCM 1244 (1990).

[93] See IRC reg. section 1.316-1(e); *Thomas W. Briggs*, 15 TCM 440 (1956); *Accessory Fashions Ltd., Inc.*, 26 TCM 507 (1967); and *Ma-Tran Corp. v. Commissioner*, 70 TC 158 (1978). Generally, if the corporation pays expenses related to the personal use of corporate assets by the shareholder, these expenses are non-deductible to the corporation and represent dividend income to the shareholder. See also *Royce C. McDougal, MD, Inc.*, 49 TCM 731 (1985).

[94] Some commentators have suggested that the IRS might reduce the basis of the US real property in the hands of the corporation by the amount of depreciation that normally would be allowed on residential rental property in the hands of a corporation. IRC reg. sections 1.1016-8(a) and (b) do provide that on the sale of a US real property interest (discussed subsequently), the taxpayer is required to reduce the basis of the property by

(The footnote is continued on the next page.)

distribution from the corporation to the shareholder. This distribution generally is treated as a dividend up to the "earnings and profits" of the corporation.[95] Deemed distributions in excess of earnings and profits are treated as a return of capital up to the basis in the stock, and then as a capital gain to the extent of any excess over such basis.[96]

The Canadian corporation will not have any earnings and profits for US tax purposes, because it has no income or deductions. Thus, the distributions are a return of basis and possible capital gains to the Canadian shareholder. This does not present a problem, however, because capital gains on the stock of a Canadian corporation are not taxable in the United States.[97]

Note that the Canadian corporation is required to make an information return each year providing the name and address of the corporation, a description of the US real property held, and any other information that the regulations ultimately may require.[98]

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[94] Continued . . .
the amount of depreciation allowable under IRC section 167(a). However, IRC section 167(a) provides that depreciation is allowable only on property used in a trade or business or for the production of income. Thus, it appears that the corporation is not entitled to a depreciation deduction on the property, and there should be no basis reduction. See *Yeager, Exr. v. US*, 58-1 USTC paragraph 9174 (Dist. Ct.).

[95] IRC sections 301 and 316. Note that the treatment of the benefit from personal use of corporate property as a dividend to the shareholder results in tax treatment for US persons who are shareholders of a corporation that is almost identical to that resulting in Canada from the application of ITA subsection 15(1). There is essentially no integration between the corporate and individual income tax systems in the United States; consequently, there is no gross up of the dividend with a corresponding tax credit such as exists in Canada. Consequently, to the extent that the corporation has earnings and profits, the shareholder using the corporate property has fully taxable income equal to the benefit, computed at fair market value rental amounts, from using the property. Thus, in neither country does the corporation derive income from shareholder use of property. Rather, it is the shareholder who derives income, a result that seems reasonable considering that it is at the shareholder level that the benefit accrues.

[96] IRC sections 301(c)(2) and (3).

[97] Article XIII of the treaty. Again, we are assuming that the Canadian corporation does not have a valid IRC section 897(i) election in place. If there were such an election, the stock of the corporation would be considered a US real property interest, and gain from the disposition of the stock would be taxable in the United States.

[98] IRC section 6039C. This section applies to any foreign person holding a direct investment in a US real property interest. IRC section 7701(a)(1) defines "person" to include a corporation. Thus, the Canadian corporation is required to comply with the information-filing provisions of this section. It appears that the penalty for non-compliance is computed under IRC section 6721. This penalty is $50 with respect to each information return that is not filed. Thus, it appears that the potential penalty for non-compliance with IRC section 6039C is $50 each year. (The penalty may be increased to $100 for each non-compliance if such failure to comply results from an intentional disregard of the information return provisions.) Incidentally, Canadian residents also should ensure that they comply with the "snowbird" filing requirements detailed in IRC section 7701(b) and IRC reg. sections 301.7701(b)-1 through 301.7701(b)-9. Discussion of these requirements is beyond the scope of this article. Generally, however, any Canadian individual who
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Unwinding the Single-Purpose Corporation

As noted previously, it may be desirable for some taxpayers to unwind an existing single-purpose corporation.[99] The shareholder(s) may determine that the costs and risks of maintaining the structure outweigh the associated benefits, or they may no longer be subject to significant US estate tax exposure under the provisions that the protocol adds to the treaty. Furthermore, other estate-planning alternatives may present a more attractive option to the shareholder(s).[100]

US Tax Consequences on the Unwinding

For US purposes, a corporation must recognize gain on the distribution of the US situs real property in complete liquidation.[101] The amount of the

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[98] Continued . . .

spends significant time (around four months) in the United States each year may be deemed to be a US resident for US income tax purposes. The Canadian will not be deemed to be a US resident if the taxpayer can show that there is a "closer connection" to Canada or that the treaty otherwise exempts the taxpayer from US residency status. Taxpayers who spend around four months or more in the United States each year should investigate these rules in detail and ensure that they complete appropriate US tax and/or information forms or statements.

[99] On the death of the current shareholder(s), the corporation no longer qualifies as a single-purpose corporation because the conditions regarding the funding of the corporation are not met. The shareholder(s) should discuss the desired disposition of the property with the heirs and the executor of the estate in advance. Depending on the circumstances, unwinding the corporation may be desirable.

[100] It also is possible that Revenue Canada may discontinue the administrative concession regarding single-purpose corporations after ratification of the protocol to the treaty. In this case, however, it may be hoped that the department will provide transitional provisions to mitigate the possible tax implications of the unwinding. Alternative planning strategies to the single-purpose corporation can include the use of insurance plans, non-recourse debt, joint ownership of property, a pattern of gifting, putting in place a buy-sell agreement with the ultimate heirs, and so forth. Taxpayers should consult their advisers regarding the various possible alternatives to the use of the single-purpose corporation, in the event that Revenue Canada decides to change its current administrative practice.

[101] We have assumed that the corporation will liquidate by distributing the US real property to the shareholder(s). IRC section 897(d)(1) provides that, notwithstanding any other provision of this chapter, "gain shall be recognized by a foreign corporation on the distribution (including a distribution in liquidation . . .) of a United States real property interest in an amount equal to the excess of the fair market value of such interest (as of the time of the distribution) over its adjusted basis." Limited exceptions to this provision are provided in IRC section 897(d)(2) and IRC temp. reg. section 1.897-5T(c)(2)(I). However, it does not appear that these exceptions apply in the current situation because the only relevant exception requires that the property be a US real property interest in the hands of the distributee, that the basis of the property be equal to or less than the adjusted basis of the property before the distribution, and that rather extensive information-filing requirements detailed in IRC temp. reg. section 1.897-5T(d)(1)(iii) be met.

An alternative approach is to sell the property at the corporate level (to the current shareholder[s], the heirs, or arm's-length third parties) and distribute the cash on liquidation. There is unlikely to be any significant difference between the two transactions for US (or Canadian) tax purposes provided that the proceeds are distributed in the same taxation

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gain is equal to the fair market value of the property at the date of the distribution in excess of the fair market value of the property at the date of acquisition.[102] This gain will be treated as effectively connected with

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year as the sale. If the corporation is not immediately liquidated, however, there may be exposure to the US branch profits tax under IRC section 884. Article X(6) does not appear to prohibit this tax in these circumstances. It also appears that the Cdn. $500,000 exemption from the US branch tax may not be available. This will not present problems if the proceeds from the sale of the property are distributed in the same taxation year, because the branch tax generally does not apply in the year of a complete liquidation.

[102] The Canadian corporation will have acquired the US real property either through a direct purchase or through a transfer from the Canadian individual shareholder(s). The basis under a direct acquisition clearly is the fair market value at the time of the acquisition. For purposes of this article, we have assumed that such direct acquisitions took place after the dates specified in article XIII(9) of the treaty.

The basis of the property is also fair market value in the case of a transfer by the shareholder(s) of the property in exchange for the stock of the corporation. For US purposes, this is a taxable transaction. IRC section 897(e) provides that any non-recognition provision of the IRC will apply on the transfer of a US real property interest only if the property received in exchange also is a US real property interest. (See IRC section 897(c) for the definition of US real property interest.) Such interest includes direct ownership of US situs real property but does not include stock in a foreign corporation that holds US real property. Because the stock in the Canadian corporation is not a US real property interest, the provisions of IRC section 351, which allow non-recognition on the transfer of property to a corporation in exchange for stock of the corporation, do not apply. Pursuant to IRC temp. reg. section 1.897-6T(a)(3) and IRC section 897(a), if the transaction does not qualify for non-recognition, it is treated as a transaction that is subject to US taxation by reason of IRC section 897.

Article XIII of the treaty permits the United States to impose tax on such transfers. The gain subject to US tax may be limited, however, by the provisions of article XIII(9). It is possible that the shareholder(s) of the Canadian corporation did not file appropriate US tax returns and pay the appropriate US tax liability in the case of a transfer of the property to the Canadian corporation. Nevertheless, the tax treatment at the corporate level remains unchanged. That is, the basis of the property to the corporation is the fair market value at the time of the transfer. The transferring shareholder(s) will remain exposed to US tax liabilities until such time as an appropriate return is filed and appropriate tax paid.

It is necessary on audit to provide support for the adjusted cost basis in the hands of the corporation. If the shareholder(s) did not report the transfer to the corporation as a taxable disposition, it may not be possible to provide the necessary support for the fair market value basis at the date of the transfer. It may be preferable in this case to report gain at the corporate level based on the original cost in the hands of the shareholder(s). This is a conservative approach and does not absolve the shareholder(s) from the tax obligation on the original transfer. However, the IRS may accept this approach and assess the tax at the corporate level, rather than assess the individual(s).

Note that if there were a loss on the original transfer, the loss would not have been deductible under the US related-party provisions of IRC section 267. However, these provisions permit the loss to offset gain on a future disposition in the hands of the corporation. Thus, if the property depreciated in value before the transfer to the Canadian corporation but subsequently has appreciated, the taxpayer should be able to reduce the gain in the hands of the corporation by the amount of loss that previously occurred. That is, the taxpayer would measure the gain at the corporate level based on the fair market value of the property less the original cost basis in the hands of the shareholder(s).

(The footnote is continued on the next page.)

the conduct of a US trade or business carried on by the corporation pursuant to the provisions of IRC section 897(a). Thus, the corporation must file a US tax return and pay US income tax based on the normal rate schedules that apply to corporations.[103] The minimum tax rate is 15 percent, and the maximum is likely to be 34 percent. There also may be US state tax imposed on the gain.

The Canadian shareholder receives the US real property in full payment in exchange for the stock of the corporation.[104] The amount of gain or loss on the distribution in exchange for the stock is the excess of the amount realized on the distribution over the adjusted basis of the stock. This amount is the amount recognized by the taxpayer for US tax purposes.[105] However, the gain is not taxable in the United States under the IRC. Consequently, the only tax liability incurred on the transaction is that incurred at the corporate level. The basis of the US real property in the hands of the former shareholder is equal to the fair market value at the time of the liquidating distribution.[106]

The corporation is not permitted to deduct a loss that results on the distribution of the property in complete liquidation (and would not benefit

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[102] Continued . . .

Also note that the taxpayer could have received non-recognition treatment on the transfer if a valid IRC section 897(i) election were in place at the time of the transfer. As detailed in footnote 82, supra, we have assumed that such an election was not filed. If a taxpayer has an IRC section 897(i) election in place, the results of the unwinding may differ from those discussed in this article.

[103] The basic US corporate tax rates are 15 percent of taxable income up to $50,000, plus 25 percent of income of $50,001 to $75,000, plus 34 percent of taxable income greater than $75,000 but less than $10 million, plus 35 percent of taxable income greater than $10 million (IRC section 11(b)). An additional 5 percent tax is imposed on taxable income between $100,000 and $335,000. Thus, taxable income between $335,000 and $10 million is subject to US federal tax at a flat rate of 34 percent. If the corporation has taxable income greater than $15 million, there is also an additional tax equal to the lesser of (1) 3 percent of the income in excess of $15 million and (2) $100,000. This clawback creates a marginal rate of 36.5 percent on taxable income between $15 million and $18.3 million and a flat rate of 35 percent on taxable income greater than 18.3 million.

It is advisable to file a US tax return even if there is a loss (or neither gain nor loss) on the property. If a foreign corporation does not file a US tax return within prescribed time periods, the United States may disallow any available deductions, including the deduction for the cost basis in computing the gain. Although it may be argued that the United States is prohibited from taking this position under provisions of the treaty, it is preferable to file the tax return so as to avoid subsequent difficulties of this nature. The return also provides information for title clearance purposes, if necessary.

[104] IRC section 331(a).

[105] IRC sections 331(c) and 1001. IRC section 1001(a) provides the rules for determining gain or loss on the exchange, while IRC section 1001(c) provides that the amount determined under IRC section 1001(a) is the amount recognized.

[106] IRC section 334 provides that the basis of the property in the hands of the distributee is the fair market value of the property at the date of the distribution if gain or loss is recognized on the receipt of the property. For the Canadian shareholder, the provisions of IRC sections 331 and 1001 result in gain recognition; however, the gain is not taxable (nor would a loss be deductible).

from such deduction in any case, inasmuch as the corporation has never had income).[107] In this case, it appears that a Canadian shareholder will lose basis to the extent of any depreciation in value on the property. The receipt of property with a fair market value that is less than the cost basis of the shares results in recognition of a loss on the exchange of the shares in the hands of the Canadian taxpayer. However, this loss is not deductible for US tax purposes (just as a gain is not taxable). Thus, the taxpayer receives the US real property with an adjusted basis for US purposes that is lower than the original cost of the property, without the benefit of a tax deduction in the United States.

In addition to US corporate tax filings on the gain, the distribution in liquidation is subject to the withholding requirements provided in IRC section 1445. Generally, these requirements impose a withholding tax obligation on the transferee of the property. However, the withholding obligation in this case falls upon the Canadian corporation itself. Thus, the corporation must withhold a tax equal to 35 percent of the amount of gain recognized on the distribution.[108] This amount, however, may actually may be lower than the normal withholding required under IRC section 1445, particularly in the case where there is no gain, or there is a loss, on the transaction. If the amount withheld is greater than the tax due on filing of the corporate return, the excess is refunded to the corporation.[109]

Canadian Tax Consequences on the Unwinding

For Canadian tax purposes, the corporation is deemed to have sold the US real property at its fair market value immediately before the liquidation

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[107] IRC temp. reg. section 1.897-5T(c)(1) provides that no loss may be recognized on the liquidation pursuant to IRC section 897(d)(1).

[108] IRC section 1445(e)(2). This requirement is in contrast to the normal withholding under IRC section 1445(a) equal to 10 percent of the amount realized on the disposition.

[109] The shareholder(s) may wish to consider simply preparing and filing the US corporate tax return immediately upon the liquidation. This may be advantageous in situations where the actual US tax rate on the gain is less than 35 percent (as is likely to be the case). Penalties imposed for non-compliance with the withholding provisions are based upon the unpaid tax due. Thus, it appears reasonable that no penalties will be assessed provided that the tax return is filed on or before the due date for the withholding tax payment. The corporation cannot file the US tax return until the end of the corporation's taxation year; however, it can be argued that the taxation year of the corporation ends at the date of the complete liquidation. (A return for a period of less than 12 months is required if a taxpayer was in existence during only part of what would otherwise be the taxable year: IRC section 443(a)(2).) The withholding tax obligation shifts to the shareholder(s) if the corporation sells the property to the shareholder(s) and subsequently distributes the cash on liquidation (see supra footnote 101). This approach may provide benefits from a withholding standpoint. The general rule of IRC section 1445(a) is that the purchaser of the property must withhold 10 percent of the amount realized on the disposition. However, IRC section 1445(b)(5) provides that there is no withholding obligation if the property is acquired by the transferee for use as a residence and the amount realized does not exceed US$300,000. Thus, the Canadian shareholder(s) will have no withholding obligation on the purchase of the US vacation property (assuming continued use as a residence) provided that the arm's-length selling price is less than US$300,000. There also are no reporting requirements in this case, pursuant to IRC reg. section 1.1445-2(d)(1).

of the corporation.[110] The gain from the disposition of the property should receive capital treatment in the hands of the corporation.[111] Thus, the corporation will be taxable on 75 percent of the gain and will receive refundable tax treatment to the extent permitted under ITA section 129. The non-taxable 25 percent of the gain becomes part of the capital dividend account of the corporation and will be distributed tax-free to the shareholder(s).[112] To the extent that taxes are payable in the United States on the gain, these taxes may be applied to reduce the Canadian tax otherwise payable.[113]

The shareholder(s) will receive a deemed dividend equal to the net proceeds of redemption in excess of the paid-up capital of the stock.[114] The proceeds of disposition on the stock will be equal to the net proceeds of redemption less this deemed dividend amount (an amount equal to the paid-up capital of the stock).[115] The dividend included in income is the total deemed dividend, less the amount of the capital dividend. The basis of the US situs real property in the hands of the shareholder(s) will be equal to the fair market value of the property at the time of the distribution.[116]

The net tax effect of these various provisions depends upon a number of factors, in particular the extent of the gain or loss for US purposes versus the gain or loss for Canadian purposes. In both cases, the gain or loss is calculated on the basis of the difference between the fair market value of the property at the time of acquisition by the corporation and the fair market value at the time of the winding up.[117] The cost base for

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[110] ITA subparagraphs 88(2)(a)(v) and 69(5)(a)(i).

[111] The sale of the US real property should give rise to capital gain treatment because the property clearly is not property in the nature of inventory. This treatment may be challenged by Revenue Canada on the basis that the property was not held for use in business or for the production of income and, thus, cannot result in capital treatment. However, we do not believe that Revenue Canada could sustain this position.

[112] The 25 percent non-taxable portion of the capital gain is included in the capital dividend account pursuant to ITA paragraph 89(1)(b). This amount may be distributed tax-free to the shareholder(s) provided that the appropriate election is made under ITA subsection 83(2).

[113] ITA paragraph 126(1)(a). The full amount of Canadian tax payable may be offset by the US tax payable, inasmuch as 100 percent of the gain on the deemed sale will be US source. Note, however, the comments in footnote 47, supra.

[114] ITA paragraph 88(2)(b) and subsection 84(2).

[115] ITA section 54, paragraph j of the definition of "proceeds of disposition."

[116] ITA subparagraph 69(5)(a)(ii).

[117] The corporation must have acquired the property either directly or through a transfer from the Canadian shareholder(s). In either case, the acquisition will be deemed to be at fair market value, because Revenue Canada has indicated that it will not permit a tax-free transfer under ITA section 85 to the single-purpose corporation. (Revenue Canada has indicated that if a taxpayer has filed an election under ITA section 85 on the transfer to the Canadian company, the corporation qualifies as single purpose, but the ITA section 85 election is not valid.) Consequently, independent of the action actually taken by the shareholder(s) on the transfer, the cost basis to the corporation is the fair market value at the date of acquisition of the US property.

Canadian tax purposes, however, will be the US dollar value of the property at the date acquired by the corporation, converted to Canadian dollars using the exchange rate in effect on that date. Similarly, the deemed selling price for Canadian tax purposes will be the fair market value in US dollars at the date of the distribution, converted to Canadian dollars using the exchange rate in effect on that date. Consequently, there may be a loss for US tax purposes and a gain for Canadian tax purposes, a loss for both, or a gain for both. If there is no gain for US tax purposes, the Canadian tax payable on any Canadian gain recognized will result in a total effective corporate and individual tax rate on the gain of approximately 36 percent.[118]

If there is a gain for both US and Canadian tax purposes, the effective tax rate depends on the amount of the gain and the corresponding US tax rate. Note that capital gains do not receive favourable treatment at the corporate level in the United States. Consequently, the US rate on gains up to US$50,000 is 15 percent; on gains between US$50,001 and US$75,000, 25 percent; and on gains greater than US$75,000, 34 percent (or higher if the gain is very large).[119] The US tax may be deducted from Canadian tax payable through the foreign tax credit mechanism. However, the foreign tax credit also reduces the amount eligible for refundable treatment under ITA section 129. As a result, the total US and Canadian (individual and corporate) tax on the gain will range from about 42 percent to about 49 percent.[120]

These tax consequences can be negative, to the extent that the combined Canadian and US taxes paid exceed those at the individual level, or if there is a loss inherent in the property. In the case of a loss, there is no

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[118] For example, if the fair market value is Cdn.$280,000, and the cost is Cdn.$240,000 (and there is no gain for US tax purposes), the corporate tax initially is equal to $11,652. However, the corporation is eligible for a $6,000 refund under ITA section 129, so that the net payable at the corporate level is $5,652. The shareholder receives a deemed dividend in excess of the capital dividend of $10,000 ($40,000 x 0.25) equal to $24,348, which results in tax at the individual level of $8,765 (assuming a combined individual tax rate on dividends equal to 36 percent after application of the dividend gross-up and dividend tax credit mechanisms). Thus, the total corporate and individual tax payable on this $40,000 gain is $14,475, or 36 percent of the gain.

[119] See supra footnote 103.

[120] For example, if the fair market value of the property is $280,000 in US dollars and the cost basis is $240,000 in US dollars, the corporation will be taxable on the same $40,000 gain in the United States as used in the example in footnote 118, supra. In this case, the entire US tax due of $6,000 ($40,000 × 0.15) will be available as a reduction in Canadian tax payable. The Canadian tax net of the foreign tax credit is $5,652. The refundable tax, however, is now only $2,000, so that the net Canadian tax payable is $3,652, for a total corporate tax of $9,652. The shareholder receives a deemed dividend in excess of the capital dividend of $20,348. The resulting shareholder tax on this dividend is $7,325 (at a total combined rate of 36 percent as noted above). Thus, the total tax payable is $16,977, for an effective rate on the gain of $40,000 equal to about 42 percent. If the US taxable gain is greater than $50,000, the US tax rate of 25 percent (up to $75,000) or 34 percent (amounts over $75,000) is imposed. At these levels, the refundable tax is eliminated, and the effective tax rates are about 46 and 49 percent, respectively.

benefit for the deduction at the corporate level, and the basis of the property in the hands of the shareholder is reduced. Consequently, the gain on a future disposition will be higher, without the benefit of a tax reduction currently.

If the unwinding of the corporation has negative tax consequences for Canadian tax purposes, the taxpayer may wish to argue that the transaction is not a disposition, according to the definition of "disposition" contained in ITA section 54. That definition indicates that a disposition does not include

> (e) any transfer of property by virtue of which there is a change in the legal ownership of the property without any change in the beneficial ownership thereof.

The taxpayer may argue that, under the administrative guidelines for qualification as a single-purpose corporation, the corporation never acquired beneficial ownership of the property. Rather, the shareholder has retained beneficial ownership from the outset, even in cases where the corporation itself purchased the property. Thus, the transfer of the property to the shareholder on the winding up merely transfers legal title back to the person who always had beneficial ownership of the property.[121] This argument suggests that the corporation is ineffective for US estate-planning purposes, but that is no longer an issue if the corporation is wound up.

CONCLUSION

There is no question that the provisions of the protocol to the treaty will serve to reduce or eliminate the exposure to US estate tax liability for most Canadian residents. However, there can still be considerable exposure to comparatively high levels of tax on death for Canadian residents who have significant worldwide and US situs estates.

Canadian residents who currently hold US situs property through a single-purpose corporation may wish to review the viability of continuing with this structure. In some cases, the benefits provided by the single-purpose corporation may continue to outweigh the costs and risks attached to the structure. It remains advisable, however, to monitor the activities of the corporation and the shareholder(s) to ensure compliance with Revenue Canada guidelines, as well as compliance with US federal and subfederal requirements regarding the corporation. On the other hand, this may be an opportune time to unwind single-purpose corporations, in view of the generally depressed real estate markets in North America.

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[121] Revenue Canada may argue, to the contrary, that beneficial ownership does reside in the corporation because any gain on the sale of the property would accrue to the corporation. On the other hand, the property clearly is not held for purposes of generating a gain on the disposition. In fact, if that were the taxpayer's express intent, it might appear that the corporation would not qualify for single-purpose status, because condition 1 may be violated. The position may be difficult to sustain if there are multiple shareholders in the corporation, but it appears to be a possibility to consider.

In any case, it is a good time to conduct a review of estate-planning alternatives in general. For many taxpayers, a solid insurance plan may be the optimal choice. Such plans can be relatively simple to implement and relatively low-cost by comparison with more elaborate estate-planning techniques. Taxpayers with large or complicated estate-planning needs may benefit from more elaborate estate-planning consultation. In all cases, it is important to remember that estate planning comes with a cost. Taxpayers should ensure that the benefits to be obtained from estate-planning techniques are greater than the attendant costs.