INVESTING US REAL ESTATE AFTER THE TCJA

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ABOUT MAX REED

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Max solves US tax problems for Canadians including:

- Adding corporations on the UX tax implications of cross-border transactions and initial public offerings;
- Helping citizens in Canada deal with US tax issues including renouncing their US citizenship; and
- Advising Canadian investment funds on investments into the United States and receiving investments from US taxpayers.

Max is the co-author (with Dick Pound of Stikeman Elliot) of A Tax Guide for American Citizens in Canada, as well as over 20 technical and plain language articles on a wide range of cross-border tax topics. Recognized for his expertise, Max is often invited to speak at conferences and seminars for tax professionals and the general public. He was invited to testify before the Canadian House of Commons Finance Committee on the impact of US tax law on Canadians.

Prior to joining SKL, Max worked at White & Case LLP, an international law firm in new York City where he provided US tax advice to individuals, corporations, and foreign states.

He holds a BA and two law degrees from McGill University, where he won several academic and leadership awards and is admitted to the bars of BC and New York.

Introduction

- This is a conference presentation Tim Barrett and I did in Toronto in January
- FAPI is his expertise (have left the slides there for a reference) – so I will focus on US issues only
- It uses Ontario rates, but the BC conclusions should not be so different
- There is a spreadsheet that justifies the conclusions in gory technical detail
- Tim did a very good paper on this topic at the 2018 CTF National Conference
- This presentation focuses on outbound tax planning for Canadian individuals and corporations investing in US real estate
- It is focused on Canadian resident individuals who are NOT US citizens, GC holders, US residents and assumes that ultimate owners have no US status

Overview

- Overview of applicable tax rules and changes
  - US corporate tax rate reduction
  - US accelerated depreciation
  - US estate tax
  - US state taxes
  - Canadian corporate tax rates and foreign tax credits
  - FAPI
- Integration Tables
- Overview of different structures
- Traps to avoid
- Conclusion

Topics not covered

- Investing in US funds for Canadian tax exempts (pensions etc)
- Canadian LP owns US REIT structure (suitable for investors)

OVERVIEW OF TAX RULES

US Tax Rate Changes

- US top federal corporate tax rate now a flat rate of 21% for all types of income
  - Reduced from 35%
  - Highest possible US corporate federal + state tax rate is now 29%
- New 20% deduction for income from pass-through entities
  - Irrelevant to Canadian residents since Canadian tax fills in the gap
  - Pass through US federal tax rate is 29.6%
  - Uneven application at the state level

US Deduction Changes

- Interest deduction limitation ⟶ For US corporations that have annual gross receipts of US$25 million or more only 30% of interest is deductible
  - No change for corporations with less than US$25 million
- 100% immediate deduction for computer software and tangible property with a recovery period of 20 years or less placed into service over next 5 years
- Additional bonus depreciation

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US Estate Tax

- Under prior law, US federal estate tax exemption was USD $5.49 million per person (2017 amount)
- With TCJA until 2025, 2018 US federal estate tax exemption is USD $11.4 million per US citizen
- Treaty allows Canadian resident similar benefit:

$$\frac{\text{US assets}}{\text{Worldwide assets}} \times (\text{US } \$11.4 \text{ million}$$

- Enhanced credit for property that passes to Canadian resident spouse
- No tax exposure if:
    - Total estate < USD $11.4 million and
    - Form 706-NA filed at the proper time

US Estate Tax - State

- Note that US state estate tax is different than the federal level;
- WA → $ 2 million exemption;
- Oregon → $ 1 million;
- May/may not follow the Treaty exemption

US Estate Tax – State – State Exemption Amounts

- **Connecticut** – $3,600,000
- **District of Columbia** – $11,400,000
- **Hawaii** – $11,400,000
- **Illinois** – $4,000,000
- **Oregon** – $1,000,000
- **Maine** – $11,400,000
- **Maryland** – $11,400,000
- **Massachusetts** – $1,000,000
- **Minnesota** – $2,700,000
- **New York** – $11,400,000
- **Rhode Island** – $1,561,719
- **Vermont** – $2,750,000
- **Washington** – $2,193,000

US State Tax

- With reduction in federal tax rate, US state taxes are more important
- Canadian general corporate tax rate ⟶ 24-27% so with 21% federal rate state tax determines whether US tax rate will be higher or lower
- Combined state and federal tax rates range from 21% ⟶ 29.6% (Iowa)
- If looking at a business expansion, do not forget state sales tax

Canadian Taxation of Outbound Investment – Foreign Affiliates

- "Foreign Affiliate" ("FA") is a foreign corporation in which the taxpayer (Canadian resident) has
  - Equity percentage of at least 1%, and
  - The total equity percentage of the taxpayer together with that of each person related to the taxpayer is not less than 10%
- Important because dividends deemed to be paid out of one of four notion surplus pools

Canadian Taxation of Outbound Investment – Controlled Foreign Affiliates

- A non-resident corporation will be a controlled foreign affiliate (“CFA”) of a taxpayer if
  - The corporation is an FA of the taxpayer, and
  - The taxpayer, persons who do not deal at arm’s length with the taxpayer, four other Canadian residents, and persons who do not deal at arm’s length with the four Canadian residents, own in the aggregate over 50% of the FA
- Only foreign accrual property income (FAPI) earned by a CFA is taxable to the taxpayer on a current basis
- Note new “tracking property” rules for taxation years of FA’s that begin after February 28, 2018

Canadian Taxation of Outbound Investment – Income Recognition

- Distributions of income or profit of an FA usually take the form of dividends
  - Dividends from non-resident corporation included in income under s.90(1)
  - Deeming rule under s.90(2) for "pro rata" distributions
  - Deeming rule under s.90(6) for "up stream loans" from an FA (targets attempts to avoid paying tax on foreign profits distributed to Canada by having FA permanently loan amounts to Canadian parent)

Canadian Taxation of Outbound Investment – Foreign Accrual Property Income

- Canada's foreign affiliate tax regime is intended to neutralize any potential tax deferral advantage that could arise by earning certain kinds of income (generally investment/passive income) offshore.

- The foreign affiliate regime achieves this objective by subjecting Canadian taxpayers to current taxation on "foreign accrual property income" ("**FAPI**") earned indirectly through a CFA, regardless of whether the income is repatriated to Canada

- FAPI is considered "aggregate investment income" of a CCPC and therefore subject to tax at a rate of 50.17% (Ontario rate). Note that the refundable portion of the tax will be added to non-eligible refundable dividend tax on hand ("**NERTOH**") account.

Canadian Taxation of Outbound Investment – Foreign Accrual Property Income

- FAPI is defined in subsection 95(1), and included in income of a taxpayer under subsection 91(1)

- Although FAPI is earned by a CFA, it is calculated according to Canadian tax rules, subject to certain adjustments

- FAPI is effectively income from a business other than an active business, which includes
  - Income from property, including income from an "investment business"
  - Income from a "non-qualifying business" (i.e., carried on in a permanent establishment located in a jurisdiction with which Canada has no tax treaty or TIEA)
  - Income that is deemed not to be income from an active business (rules found in s.95(2)(a.1) to (b) and target various potential avoidance transactions)

Canadian Taxation of Outbound Investment – Deductions and Credits

- Subsection 20(11) provides a deduction in respect of foreign income or profits tax paid by individuals in respect of income from a property
  - Limited to amount by which foreign taxes exceed 15% of income inclusion
- Subsection 20(12) provides a deduction form “non-business income tax” by the taxpayer in computing the taxpayer’s income from a business or property
  - Not available to corporation in respect of shares of an FA; often useful if individual holds interest in an LLC
- Section 126 foreign tax credit is calculated both in respect of “business income tax” and “non-business income tax” paid to a government of a country other than Canada
  - Not available to corporation in respect of shares of an FA
- Subsection 91(4) entitles taxpayers to a deduction for foreign taxes paid by the CFA that can reasonably be considered to relate to FAPI. Subsection 91(4) together with subsection 91(5) avoids double tax on FAPI included in Canadian taxpayer’s income.
- Subsection 113(1) contains the deductions for dividends received by a Canadian corporation on shares of a foreign affiliate.

INTEGRATION TABLES

Outbound Integration: US Rental Income

Assumes: effective US corporate tax rate 26%; US individual rate 34%; Cancos have PEs in Ontario; USCo and US LLC are CFAs; Assumes s. 199A deduction applies to individual/LP; Applies BPT + average 5% US state tax rate

	Individual / Partnership	Canco Over USCo	Canco With Branch		Canco Over US LLC	
US Tax	34	29.70	29.70		48.20	
Taxable income	100	74	100		100	
Canadian tax deduction on distribution		(74)	-		(200)	*
Canadian tax before foreign tax credit	53.53	-	50.17		-	
Foreign tax credit	(34.00)	-	(29.70)		-	
Canadian corporate tax	-	-	13.36	*	-	
Dividend type	-	Eligible	Ineligible		Eligible	
Fully-distributed effective tax rate	53.53%	57.36%	70.05%		68.58%	

Outbound Integration: Disposition of US Real Estate

Assumes: effective US corporate tax rate 26%; US individual federal tax rate 20%, Cancos have PEs in Ontario; USCo and US LLC are CFAs; Applies BPT + average 5% US state tax rate to corporate scenarios

	Individual / Partnership	Canco Over USCo	Canco With Branch	Canco Over US LLC	
US Tax	25.50	29.70	29.70	48.20	
Taxable income	50	74	50	100	
Canadian tax deduction on distribution		(74)	-	(150)	*
Canadian tax before foreign tax credit	26.76	-	25.09	-	
Foreign tax credit	(25.50)	-	(25.09)	-	
Canadian corporate tax	-	-	-	-	
Dividend type	-	Eligible	Ineligible	Eligible	
Fully-distributed effective tax rate	26.76%	57.36%	39.32%	68.58%	

Disposition of US Real Estate (Canada)

- As preceding slide shows, it is more tax-efficient for a Canadian taxpayer to dispose of US real estate directly in order to tax advantage of the advantageous Canadian inclusion rates.
- Where a Canadian taxpayer cannot dispose of US real estate directly, potential planning opportunities can be considered.
- Often, the ETR for a CCPC will be better on a fully-integrated basis if a US CFA that disposes property is wound-up into the CCPC under subsection 88(3) – a “qualifying liquidation and dissolution” (“QLAD”)
- Although the CCPC will lose the benefit of tax paid in the US on the disposition, a QLAD may generate a capital gain (and therefore CDA). The results must be assessed on a case-by-case basis.

Disposition of US Real Estate (US)

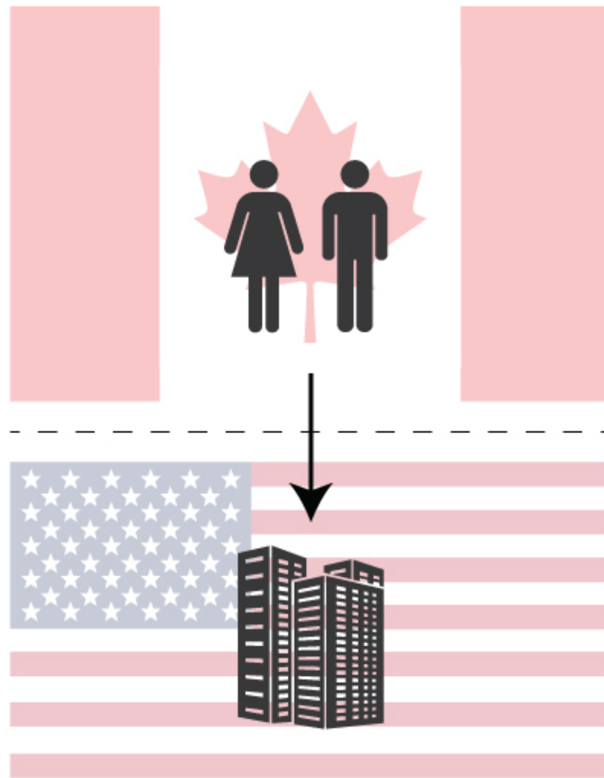
- To avoid BPT on the exit of the US real estate, the corporation has to completely exit from US investments
- The sale cannot be made to a related party
- Within three years the sale cannot be used to invest in another USTB

DIFFERENT STRUCTURES

Overview

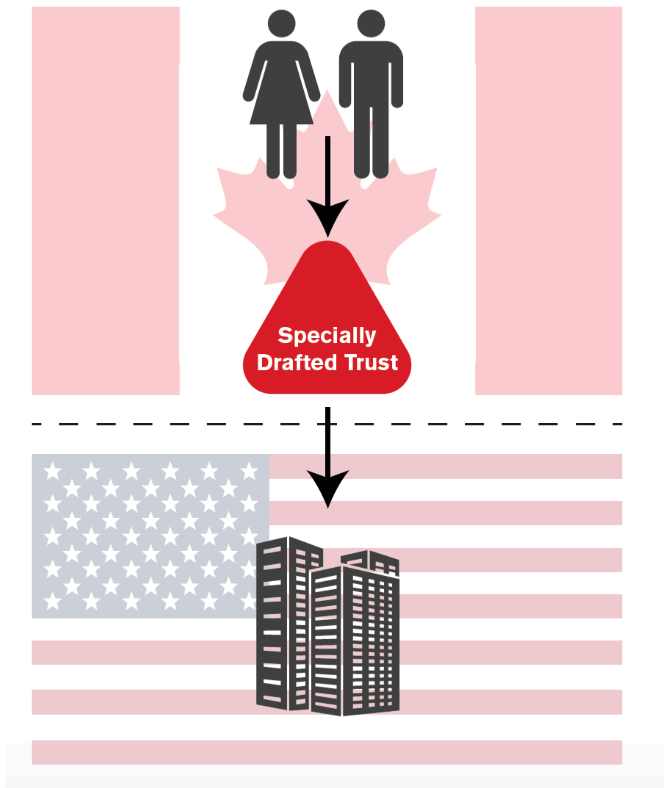
- This section highlights some different structures for investment into US real estate and US real estate purchase:
  - Personal ownership (real estate only)
  - Specially drafted trust (real estate only)
  - Canadian LP
  - Hybrid LP
  - Canadian corporation owns US corporation
- Note – uses Ontario tax rates – conclusion not much different than BC

Personal Ownership



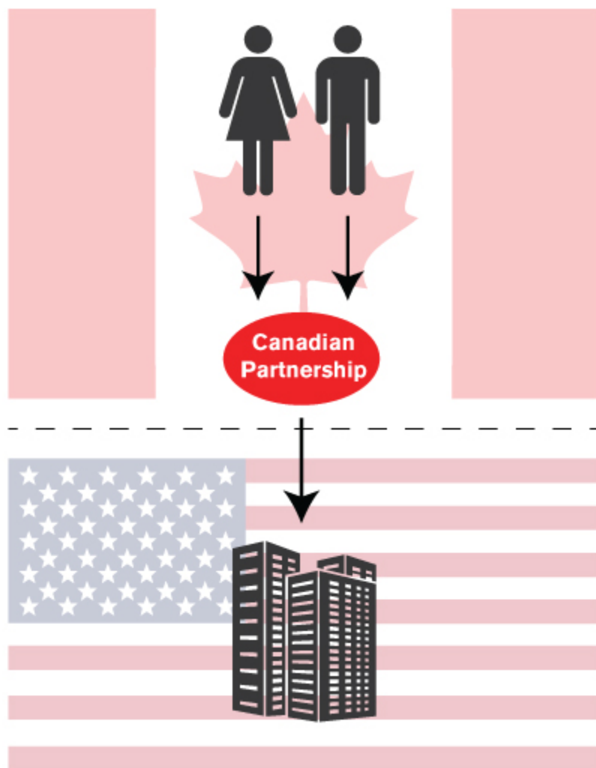
Rental Income	53.53%
Capital Gains	26.76%
Obligation to File US Returns?	YES
Estate Tax Exposure?	YES

Specially Drafted Trust



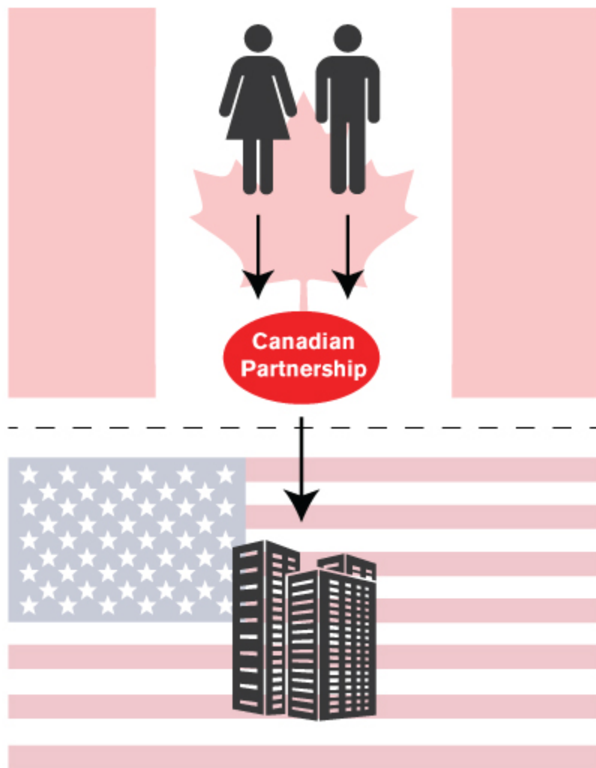
Rental Income	53.53%
Capital Gains	26.76%
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

Canadian Partnership



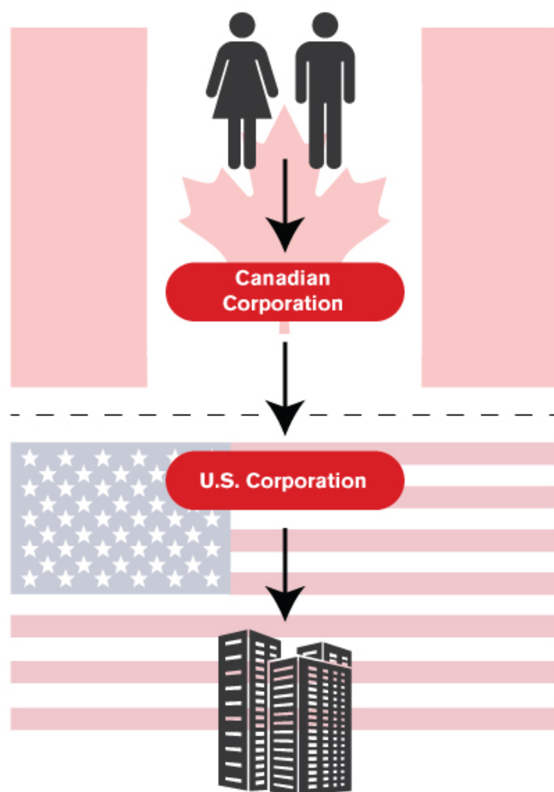
Rental Income	53.53%
Capital Gains	26.76%
Obligation to File US Returns?	YES
Estate Tax Exposure?	POSSIBLE BUT UNLIKELY

Hybrid Partnership



Rental Income	53.53%
Capital Gains	26.76%
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

Hybrid Partnership



Rental Income	57.36% (assuming fully distributed to shareholders)
Capital Gains	57.36% (assuming fully distributed to shareholders)
Obligation to File US Returns?	YES
Estate Tax Exposure?	NO

TRAPS TO AVOID

Traps to Avoid

- Don’t use LLCs to own US real estate ⟶ Problems!
- Don’t use US revocable living trusts ⟶
  - Taxable disposition in Canada when property is contributed to RLT unless it is a spousal/Alter Ego Trust
  - 5472 filing requirement ⟶ USD $10,000 penalty
  - T3 filings in Canada
- Avoid using probate avoiding mechanism in the US ⟶ may rise to the level of a disregarded entity
- Ensure that Canadian wills work in US jurisdiction

Traps to Avoid

- Don't forget to make election to have net rental income taxed as ECI under 871(d)/882(d)
- If using LPs to own US real estate, don't forget about:
  - Quarterly withholding on distributions of ECI/Rental income
- If using foreign corporation ⟶ consider branch profits tax on exit from investment
  - Need to have corporation terminate all US investments
- Don't use Canadian corporation for real estate that is used personally
  - Shareholder benefit issued under 15(1)
- Don't gift US real estate to family members → US gift tax/capital gain in Canada

Traps to Avoid

- Relying on estate tax exemption is generally fine
- However, note that estate has to file Form 706-NA to claim treaty benefits
- 706-NA requires valuation under US tax principles of all assets held by the estate
- So if complex financial picture in Canada, even if no estate tax owing, cost of 706-NA on death may exceed cost of using estate blocking structure

Traps to Avoid

- Restructuring to avoid US federal estate tax:
  - Transfer US real estate to Canadian LP/LLP → tax neutral
  - Sell to specially designed trust – may trigger capital gain

Traps to Avoid

- The reduction in the US federal corporate tax rate from 35% to 21% will likely increase compliance burden:
- **State tax**. In order for state tax to be creditable or deductible in Canada, it must be an “income or profits tax”. Generally, this is tax imposed on net income.
  - Some states taxes may not qualify as income or profits tax, and therefore not be creditable or deductible (e.g., franchise taxes)
  - Even if state taxes do qualify as income or profits tax, they may not be high enough so that US-source income earned by a US CFA meets the 25% threshold for no FAPI inclusion (assuming that the tax bases are the same for US and Canadian tax purposes)
  - These issues could effectively be ignored when the federal rate was 35% because that rate usually generated sufficient FAT or UFT

Traps to Avoid

- **Mind and management in the USA.** For Canadian surplus purposes, an FA is only "resident" in a "designated treaty country" (such as the US) if central management and control is exercised US
  - If a US FA is not resident in the US for surplus purposes, then income from an active business carried on the FA in the US will be added to "taxable surplus" (rather than exempt surplus) and it will be necessary to track UFT and UFT applicable.
  - This issue could usually be ignored when the US federal rate was 35% because there would usually be sufficient UFT and UFT applicable for full deductions by CCPC for FA-sourced income in Canada
  - Also remember also that a fiscally-transparent LLC that is centrally management and controlled in Canada will be considered a resident of Canada for Canadian tax purposes

"Private corporations paper": NERDTOH/ERDTOH

- New non-eligible refundable dividend tax on hand (NERDTOH)/ eligible refundable dividend tax on hand (ERDTOH) regime can result in "trapped" GRIP where a CCPC owns an interest in a fiscally transparent LLC that is a CFA and earns FAPI
  - If FAPI earned by the LLC is not repatriated in the year it is earned, then the CCPC will pay refundable tax, which will be added to NERDTOH. When the income is eventually repatriated, the CCPC will get GRIP. However, depending on whether a loss can be generated to eliminate refundable tax in the earlier year, the CCPC will need to pay out non-eligible dividends to get the refund.

“Private corporations paper”: TOSI

- The new tax on split income (TOSI) rules can result in double taxation if a “specified individual” earns “split income” on shares of a CFA
  - If a specified individual has an income inclusion under subsection 91(1) in respect of the shares of a CFA, the amount of the income inclusion is added to the adjusted cost base (ACB) of the individual’s shares in the CFA
  - If the CFA later pays out a dividend on those shares, usually the individual can take a deduction under subsection 91(5) to the extent that the amount has effectively already been taxed in Canada
  - However, a subsection 91(5) cannot be taken to reduce that income inclusion to the extent that the dividend is “split income” to the individual. That said, the individual may have other uses for the deduction

“Private corporations paper”: SBD

- Additional restriction on a corporation’s business limit based on the passive income of the corporation and its associated corporations.
- New definition “adjusted aggregate investment income” (“AAII”) is calculated without reference to FAT deduction.
- This could result in double counting passive income earned by a CFA for purposes of the SBD restriction even if full FAT (i.e., income will be included in AAII of CFA and AAII of Canadian parent as if no subsection 91(4) deduction).

CONCLUSIONS

Conclusions

- After corporate rate cut drop, corporations are a more appealing way to own US real estate
  ⟶ particular if cash comes from a corporate source
- But beware complexities of FAPI etc. or large tax cost on branch investment
- Individual ownership/LPs remain preferable
- Analysis will depend on source of funds and tax cost to extract funds