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Article abstract

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The second part of this paper analyses the U.S. income tax legislation related to Canadian taxpayers who invest in U.S. real estate. Should the taxpayer use a corporation to hold the investment? Should that corporation be Canadian or American? These questions trigger a number of potential tax problems, some of which are discussed in this paper.

DROIT COMPARÉ

Chronique de législation

Canadian Taxpayers Investing in U.S. Real Estate

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RÉSUMÉ

Nombreux sont les contribuables canadiens qui passent une partie de l'année aux États-Unis, tout en demeurant résidents canadiens. Les nouvelles règles de résidence américaine déterminant le statut fiscal du contribuable jouent un rôle important dans la planification de la vie d'un individu. Dans la première partie de cet article, l'auteur analyse la législation américaine applicable afin d'informer le contribuable des pièges fiscaux qui le guettent en matière de résidence.

Dans un deuxième volet, il analyse les divers mécanismes d'imposition américaine applicables lorsqu'un contribuable canadien investit dans le secteur immobilier aux États-Unis. Le contribuable devrait-il créer une corporation qui serait propriétaire de l'investissement? Cette corporation devrait-elle être canadienne ou américaine? Ces questions génèrent de nombreuses

ABSTRACT

A fair amount of Canadian taxpayers spend a substantial period of the year in the United States while retaining their Canadian resident status. New income tax rules in the United States related to the notion of residence play an important rule in the planning of the life of a taxpayer. The first part of this paper focuses on the American legislation in order to warn the taxpayers about the potential income tax consequences of spending time in the United States.

The second part of this paper analyses the U.S. income tax legislation related to Canadian taxpayers who invest in U.S. real estate. Should the taxpayer use a corporation to hold the investment? Should that corporation be Canadian or American? These questions trigger a number of potential tax problems, some of which are *interrogations fiscales, dont certaines sont étudiées dans cet article.*

discussed in this paper.

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INTRODUCTION

Every winter, a good number of Canadians pack their suitcases, clean their golf clubs and head off for the better climate of Florida without even feeling sorry for those who stay behind. A portion of those people will rent a place in Florida whereas some others will buy a home or a condominium, hoping that their investment will generate a substantial profit on the disposition.

Obviously, Canadian real estate buyers in the United States are not restricted to the tourists. The reasons for investing in the U.S. are numerous but one may suspect that the political stability and the potential tax sheltering of the profit might influence a large number of those investors.

This paper will focus on some tax aspects related to the holding of real estate in the United States by a Canadian taxpayer. However, before we reach that stage, we feel that it would be important to first analyze the new rules of residence in the U.S. since this aspect of the problem will drastically influence the tax analysis that one will have to make before investing in the real estate business.

I. EXPLANATION OF THE GENERAL PRINCIPLES OF U.S. TAX LAW WITH RESPECT TO INCOME EARNED BY FOREIGN TAXPAYERS

The general principles to be applied in determining the income subject to tax in the United States when earned by a Canadian taxpayer are, in some respect, similar to the rules enacted by the Canadian *Income Tax Act*[1] with respect to foreign people.

First, like the American taxpayer who engages in business in Canada and pays tax at the regular tax rate,[2] the Canadian taxpayer will be subject to the regular U.S. tax rate established by the *Internal Revenue Code* on his taxable income which is effectively connected with the conduct of a trade or business within the U.S.[3] Secondly, The American taxpayer who gets passive income from a Canadian source will be subject to a 25 % withholding tax,[4] except in cases where the *I.T.A.* provides for a specific exclusion[5] like the interest on government bonds or when the treaty provides for a reduced tax rate.[6]

Similarly, the Canadian resident receiving fixed, determinable, annual or periodical gain, profit or income in the United States is subject to a 30 % withholding tax.[7] However, exceptions to that rule cover a broader range than those enunciated in the *I.T.A.* For example, interest paid by a U.S. bank to a non-resident alien is not subject to withholding[8] as well as the interest paid on certain portfolio debt instruments.[9]

As far as the capital gains are concerned, the *I.T.A.* taxes the gain of a real property held by a non-resident like any other taxable capital gain received by a Canadian taxpayer.[10] Under the *I.T.A.*, only one half of the taxable gain is included in the income regardless of the holding period.[11] Under the *I.R.C.*, the capital gain received by a non-resident

1. S.C. 1970-71-72, chap. 63, as amended (hereinafter cited as *I.T.A.*).
2. *I.T.A.*, s. 115.
3. *Internal Revenue Code*, 26 U.S.C. (1985) (hereinafter cited as *I.R.C.*), s. 871(b).
4. *I.T.A.*, s. 212.
5. *I.T.A.*, par. 212(1)(b).
6. Convention between Canada and the United States of America with respect to taxes on income and on capital signed on September 26, 1980, as amended by the protocols signed on June 14, 1983 and March 28, 1984. See: *Canada — United States Tax Convention Act*, S.C. 1983-84, chap. 20.
7. *I.R.C.*, s. 871.
8. *I.R.C.*, s. 861(c).
9. *I.R.C.*, s. 871(h).
10. *I.T.A.*, par. 115(1)(b).
11. However, S.C. 1986, chap. 6, s. 110.6 provides for a $250,000 lifetime exemption of taxable capital gains.

alien (other than the disposition of a United States real property interest)[12] is taxed at the flat rate of 30 % only if the individual is present in the United States for a period or periods aggregating 183 days or more during the taxable year where the sale or exchange occurs.[13] The 30 % tax will apply on the excess of the gains over losses that are allocable to sources within the United States.

However, when a gain or loss derived from the disposition of a U.S.R.P.I., the gain will be treated as effectively connected with a trade or business.[14] Consequently, the non-resident alien individual or the foreign corporation will be subject to the regular tax rules, with a fixed rate of 20 % for individuals. Briefly stated, these rules provide that when a capital asset is held for a period of more than 6 months, the gain, then called a long-term capital gain, will be subject to a 60 % deduction in the calculation of the gross income of an individual.[15] Since the maximum tax rate applicable to an individual is 50 %, the practical result is that the long-term capital gain of an individual cannot be subject to a tax higher than 20 %.

Since the rules of the *Foreign Investment in Real Property Tax Act (F.I.R.P.T.A.)* only apply to non-resident alien individual and to foreign corporation, we shall now devote a few pages to the definition of those terms.

II. Definitions

A. NON-RESIDENT ALIEN INDIVIDUAL

Unlike Canada, the United States taxes its people not only on the basis of residence, but also on the basis of citizenship. Obviously, this latter test is the cause of major concerns since the U.S. citizen living in Canada is still liable on his world wide income for U.S. tax purposes although he does not have any physical connection with that country nor any intention to return.

The new residence test found in the *I.R.C.* is somewhat similar to the statutory residence test found in the *I.T.A.*, except that the former is much more extensive. Under the *I.T.A.*, residence can be established in two ways. First, regardless of the amount of time spent in Canada, if

12. *I.R.C.*, s. 897(c). A United Stated real property interest is hereinafter cited as U.S.R.P.I.

13. *I.R.C.*, s. 871(a)(2).

14. *I.R.C.*, s. 897(a). For a definition of U.S.R.P.I., see *infra*, note 37.

15. *I.R.C.*, s. 1202(a). The reader should be aware that the 60 % deduction is computed with reference to the net capital gain, which then takes into account other factors such as long-term capital loss, short-term capital gain and short-term capital loss.

the individual has enough connections with the country, then he will be deemed to be resident for the whole year; his world wide income then becomes subject to Canadian tax.[16] The second test merely considers the amount of time spent in Canada, regardless of the intention of the taxpayer. The mere presence (sojourn) in Canada for a period of 183 days or more during the year triggers the same tax consequences for that year as if he were resident under the first test.[17] In the computation of the 183 days, no reference is made to the time spent in the country in prior years.

The tax reform of 1984 has brought novelty in the *I.R.C.* in two ways: first, it has included a statutory definition of the term "resident";[18] furthermore, the enactment is not at all a codification of the judiciary decisions rendered up to that time. Under the prior law, two factors were required to exist before an individual could be found resident of the United States. They were 1) physical presence in the United States, and 2) an intention to reside in the U.S. with some permanence.[19].

Before we analyze more in depth the new provisions, it is interesting to note that a failure to meet the requirements will prevent the I.R.S. from looking at other factors in order to find the alien to be a resident of the United States. In contrast, the *I.T.A.* applies the 183 days test only to those who sojourn in Canada, such as tourists or travellers. On the other hand, as we mentionned, the mere presence for one day in Canada during the year might trigger all the ordinary tax consequences applicable to regular residents if enough connections are present.

The House Ways and Means Committee justifies the new test by a "need to establish more guidance with respect to resident status".[20] As we will analyze, the new test merely considers the physical presence and thus, fails to take into account the intent of the alien. It would seem that by wanting to establish better guidelines, these tests might cost the government additional revenues and may be the United States may even be used as a potential tax heaven!!!

B. ANALYSIS OF THE NEW TEST

An alien individual shall be treated as a resident of the United States and taxed on his world wide income with respect to any calender year if he meets one of the following requirements. 1) The alien is a lawful permanent resident of the United States under the immigration laws at any

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16. *I.T.A.*, ss. 2(1), s. 3. *Thomson* v. *M.N.R.*, [1946] S.C.C. 209.
17. *I.T.A.*, ss. 250(1).
18. *I.R.C.*, s. 7701(b).
19. Treas. Reg., s. 1.871(2)(b), sec. *United States* v. *Rexact,* 558 F. 2d 37 (2nd Circ. 1976), *Rev. Rul* 70-506, 1970-2 C.B. 1.
20. H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1523 (1984).

time during the calendar year (green card test). 2) The alien meets the substantial presence test.

Under this latter test, the Act takes into account, in the computation of the 183 days, a certain fraction of the number of days spent in the United States in the two preceeding years. If the sum of the days spent in the United States in the current year, plus ⅓ of the number of days spent in the United States in the immediate preceding year, plus ⅙ of the number of days spent in the United States in the second preceding year equals or exceeds 183 days, then, this individual becomes taxable in the United States on his world wide income.[21]

However, because of the harsh consequences triggered by this test, it was felt necessary to create some exceptions to the rule. First, a presence of less than 31 days in a calendar year will not be deemed sufficient to meet the substantial presence test for that year.[22] Second, in cases where the alien would be deemed to be resident for the year under the aggregate test and where he spends fewer than 183 days in the United States during that year, he will be deemed not to meet the substantial presence test if he can establish that he has a tax home in a foreign country and has closer connection to such foreign country than the United States.[23]

Although these two exceptions may provide some relief to the taxpayer for the current year in question, one has to know that the number of days spent in the United States will still be counted for purposes of establishing the residence for the future years to come.

In the next set of exceptions, the exemption is more complete and treats the individual as not being present in the United States. Consequently, should the individual come back in the United States while not covered by the exemption, the number of days spent in the United States while covered by the following exceptions will not be counted under the aggregate method.

1) The Individual Is Unable to Leave the U.S. Because of a Medical Condition Which Arose While the Individual Was Present in the U.S.[24]

It is interesting to note that if a Canadian citizen comes in the United States for say, a heart transplant, the exemption does not apply since the medical condition did not arise while being in the United States. In this case, this poor taxpayer will not only be afflicted with a tremendous

21. *I.R.C.*, s. 7701(b)(3)(A)(ii).
22. *I.R.C.*, s. 7701(b)(3)(A)(i).
23. *I.R.C.*, s. 7701(b)(2)(B).
24. *I.R.C.*, s. 7701(b)(3)(D).

medical bill, but Uncle Sam might pay him a visit. Considering the purpose of the stay, we feel that the statute should be modified to cover such cases.

This inequity is explained by the House Ways and Means Committee in the following way:

> The Committee also believes, however, that the Federal Government has contributed to the creation of medical facilities in the United States that are second to none in the world and that aliens who come here to the United States for medical treatment and stay for extended periods of time should be subjected to the bill's regular rules.[25]

Obviously, the Canadian taxpayer receives the protection of the treaty; however, this relief is only valid in so far as a provision of the treaty applies.

2) The Alien Is a Student, Trainee or Teacher.[26]

This exception will apply for students for a maximum of 5 years, unless he can prove that he does not intend to permanently reside in the United States and he complies with the requirements for being so present.[27]

For the teachers and trainees, the exclusion is limited to a maximum of two years. However, if this individual has been a student under a J-visa or an F-visa or a teacher or trainee for any two calender years during the preceeding two years, the exemption will not apply. However, if the alien is a student in the current year, he will be allowed to spend 5 years in the United States (as explained above) even though he has taught for two years during the first two years of his stay.

It is interesting to note that the timing plays a very important role here. For instance, the Canadian professor who wishes to study in an American university and plans to teach thereafter in the United States for a limited number of years would be well advised to start his stay by teaching for two years and then, he could study for a maximum of 3 years (with possible extension), whereas should he choose the opposite route and study for two years, he will be treated as a resident of the United States when he is in the United States as a teacher.

However, there might be some situations where the teacher might prefer to be treated as a resident. For instance, when this person earns more than $10,000 U.S. in the year as a non-resident teacher, there will be a 30 % tax withheld on his gross wages without regard to the expenses that he might have incurred in the pursuance of his employment. Should

25. H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1525 (1984).
26. *I.R.C.*, s. 7701(b)(4)(A).
27. *I.R.C.*, s. 7701(b)(4)(D) & (E).

this teacher be treated as a resident, he will pay tax at the normal progressive tax rate and will be entitled to all the regular deductions of a U.S. citizen. This could well result in an effective tax rate inferior to 30 %.

In both cases, the tax paid in the United States will be used as a foreign tax credit in the computation of the Canadian tax.[28] However, it is still preferable to pay the lowest tax possible in the United States since the foreign tax credit might, in some cases, exceed the Canadian tax payable and in this case, a reimbursement is not granted to the taxpayer by the Canadian government.

3) The Alien Regularly Commutes to Employment or Self-Employment in the U.S. While His Place of Residence Is in Canada or Mexico.[29]

Once again, if most of the taxpayer's employment income is from the United States, this provision may prove disadvantageous to the alien since he will be treated as a non-resident and subject to the 30 % withholding tax. However, if most of his income is from a source outside the United States, then, being treated as a non-resident may be beneficial.[30]

C. FOREIGN CORPORATION

Unlike Canada, the United States uses only the situs of incorporation test in determining whether a corporation is foreign or domestic.[31] Any corporation created outside the United States will be qualified as a foreign corporation even though its central management and control is located in the United States. In this instance, this type of corporation, under Canadian law, would be a resident corporation[32] for that particular year, thus taxed in Canada on its world wide income.

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28. *I.T.A.*, s. 126.

29. *I.R.C.*, s. 7701(b)(6)(B). The reader should be aware that some exceptions of less importance have been left out in the redaction of this paper.

30. See: F. Chopin, "Preimmigration tax planning", Canada — U.S. Tax Conference, Laval University, 1986, p. 11: "The recently introduced *Technical Corrections Act* of 1985 (H.R. 1800 and S. 814) increases the exemption period for teachers and trainees, all of whose compensation would otherwise be exempt from tax under the *Mutual Educational and Cultural Exchange Act,* to a maximum of four calendar years. Under the bill, days spent working in the United States as a teacher or trainee during four calendar years in any seven calendar year period do not count as days of U.S. presence for purposes of the substantial presence test if all of the individual's compensation is described in Code section 872(b)(c)."

31. *I.R.C.*, s. 7701(a)(4) & (5).

32. *I.T.A.*, ss. 250(4).

III. INVESTING IN THE U.S. REAL ESTATE

A. THE PRE-*F.I.R.P.T.A.* ERA

Before the enactment of *I.R.C.* s. 897,[33] the gain derived from the disposition of real property in the United States by a non-resident alien was taxed in the United States only if one of these two conditions occurred:

(i) if the foreign investor was engaged in a trade or business in the United States and the gain was effectively connected with the conduct of a trade or business within the United States, or

(ii) in the taxable year that the gain occurred, if the non-resident alien individual was present in the United States for more than 182 years.

These tests had been introduced in 1967 by the *Foreign Investors Tax Act*[34] in an effort to eliminate the harsh treatment that existed with respect to non-residents. However, it soon became evident that this modification made it relatively too simple for a taxpayer to avoid payment of U.S. tax upon disposition of the real property. For example, one could merely sell the real property on an installment basis and defer the payment until the next year where the gain would no longer be connected with a trade or business,[35] thus free of U.S. tax.

One other method involved the use of a corporation that held the property. This corporation could liquidate and avoid the gain through *I.R.C.* s. 337. The proceeds would then be distributed to the shareholders who would not realize a gain since the holding of stock did not generally constitute a trade or business.

The shareholder could also have sold the shares at a price relecting the increase in value of the real property and the buyer could then liquidate the corporation without realizing a gain.

However, local taxpayers felt that the foreign investors were given an undue tax preference which drove up, according to some, the price of farm acreage to the disadvantage of the United States farmers.[36] In an effort to correct those abuses, *I.R.C.* s. 897 was enacted in 1980. As we will analyze, the philosophy has now been completely reversed as complex anti-avoidance rules have been promulgated in order to prevent most gains derived from U.S. real property from escaping the grasp of Uncle Sam.

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33. S. 897 was adopted under the *Foreign Investment in Real Property Tax Act* of 1980, P.L. 96-499, s. 1122.

34. P.L. 89-809, 80 Stat. 1539 (1966).

35. Treas. Reg., s. 1.864-3(a) & (b) Ex. 1.

36. FEDER, PARKER, "The Foreign Investment in Real Property Tax Act of 1980", (1980-81) 34 *The Tax Lawyer* 548. These authors refer to a magasine that reported that German investors are thought to own almost 40 000 square miles of U.S. farm properties: O'Donnel, Drang Nash U.S.A., Forbes, July, 7, 1980, at. 82.

B. DEFINITION OF U.S.R.P.I.

1) Interest in Real Property

Any interest in real property[37] (including an interest in a mine, well or other natural deposit) located in the United States or the Virgin Island constitute a U.S.R.P.I.

The interest in real property includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon.[38] It also includes movable walls, furnishings and other personal property associated with the use of the real property.

In order to get a clearer picture of what constitutes an interest in real property, we will divide our analysis in three parts:
a) land and unsevered natural products of land,
b) improvements, and
c) personal property associated with the use of the real property.

a) Land and Unsevered Natural Products of Land

In that respect, the regulations indicate that crops and timber cease to be real property at the time they are severed from the land. Ores, minerals and other natural deposits cease to be real property when they are extracted from the ground.[39]

b) Improvements[40]

Improvements include not only buildings but also inherently permanent structure and the structural components of either, such as walls, floors, windows, doors, plumbing, etc. Generally, the structural components of a building are those required for its operation and maintenance, as opposed to the operation and maintenance of the machinery and equipment. The regulations also indicate that any property that is in the nature of machinery under Treas. Reg. s. 1.48-1(c)[41] or essentially an item of machinery and equipment under Treas. Reg. s. 1.48-1(e)(1)(i) is not an inherently permanent structure.

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37. *I.R.C.*, s. 897(c)(1)(A)(i).
38. *I.R.C.*, s. 897(c)(6).
39. Treas. Reg., s. 1.897-1(a)(2)(b)(2) (1985).
40. Treas. Reg., s. 1.897-1(a)(2)(b)(3) (1985).
41. *I.R.C.*, s. 48 deals with the investment tax credit.

c) Personal Property Associated with the Use of the Real Property[42]

This category embraces property used in the operation of the real property that falls into one of these four categories.

Property used in mining and forestry

This category includes the equipment used predominantly to exploit unsevered natural products in or upon the land. It also includes any property used to cultivate the soil and harvest its products such as farm machinery, draft animals and the equipment used in the growing and cutting of timber. However, once the natural product has been severed from the land, the equipment used thereafter is not associated with the use of real property.

Property used in the improvement of real property

This category covers property that is predominantly used to construct or otherwise carry out improvements to real property.

Property used in the operation of a lodging facility

This category includes mainly the property used in connection with the operation of a lodging facility, such as furniture, equipments (stoves, ranges . . .). The term lodging facility does not include a personal residence occupied solely by its owner, or a facility used primarily as a means of transportation (such as an aircraft, vessel or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided. This regulation will then allow a Canadian taxpayer who owns a dwelling unit in Florida, for instance, for his own convenience to sell the furniture of this place without incurring any U.S. tax liability.

Property used in the rental of furnished office and other space

This title speaks by itself.

The consequence of having personal property which has become associated with the use of a real property is that, when this personal

42. Treas. Reg., s. 1.897-1(a)(2)(b)(4) (1985).

property is disposed of, it shall be treated as real property interest unless one of these two conditions is met: 1) The disposition of the personal property occurs more than one year before or after the disposition of any present right to occupy or use the real property with which it was associated. 2) The personal property and the real property with which it was associated are separately sold to persons that are related neither to the transferor nor to one another.

2) Interest in a Domestic Corporation That Is a United States Real Property Holding Corporation[43]

After having analyzed the concept of direct ownership in an interest in real property, we now turn our attention to the holding of an interest in a domestic corporation[44] which qualifies as a United States real property holding corporation.[45] Any such interest is considered to be a U.S.R.P.I. unless it is proven that the corporation is not a U.S.R.P.H.C. during the testing period[46] of 5 years or unless the interest is merely an interest as a creditor.

a) Interest Other Than as a Creditor

When this legislation was enacted, the draftman did not contemplate the taxation of the gain resulting from a straight debt. However, the question as to whether an interest is solely an interest as a creditor might be a very tenuous one. The regulations define the interest other than as a creditor[47] in the following manner:

(i) the holding of stock in the corporation,
(ii) an interest in a partnership as a partner,
(iii) an interest in a trust or estate as a beneficiary,
(iv) an interest which is in whole or in part, a direct or indirect right to share in the appreciation in value of an interest described above or a direct or indirect right to share in the appreciation in value of assets of, or of gross or net proceeds or profits derived by, the entity, or
(v) a right (whether or not exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner, an interest described in the above.

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43. *I.R.C.*, s. 897(c)(1)(A)(ii).
44. *I.R.C.*, s. 7701(a)(4).
45. *I.R.C.*, s. 897(c)(2) (hereinafter cited as U.S.R.P.H.C.).
46. *I.R.C.*, s. 897(c)(1)(A)(ii)(I) & (II).
47. Treas. Reg., s. 1.897-1(d)(3)(i) (1985).

As far as the creditor is concerned, if his debt contains some form of equity features, this will make it a U.S.R.P.I. (provided the other requirements are met). For instance, if the interest of the creditor includes a right to a payment which is contingent on the appreciation in value[48] of an interest described above, or which is contingent upon the earnings and profits of the entity. However, an interest reflected by the mere rights attached to a mortgage (respossession and foreclosure) will not in itself constitute an interest other than solely as a creditor.

b) Testing Period

An interest in a domestic corporation will be deemed to be a U.S.R.P.I. unless the taxpayer establishes that the corporation was, at no time, a U.S.R.P.H.C. during the shorter of:[49]

— the period after June 18, 1980 during which the taxpayer held such interest, or

— the 5 year period ending on the date of the disposition of such interest.

This rule might produce harsh result that were totally unexpected. For instance, if a domestic corporation was a U.S.R.P.H.C. because it held mainly U.S.R.P.I. but decided to liquidate all its real property interest and to replace it with real property located in Canada and only one real property located in the United States of a minimal value, the sale of the shares of this domestic corporation held by a Canadian taxpayer will trigger the application of *I.R.C.* s. 897 if it occurs within 5 years following the liquidation of most of its U.S.R.P.I. However, this waiting period is not required if the corporation has ceased at that particular time to own any U.S.R.P.I. and has recognized the gain on such dispositions. In our example, if this corporation had not repurchased a real property located in the United States, the sale of the shares would not have triggered the application of *I.R.C.* s. 897.

This testing period and its desastrous consequences will be better understood by analyzing the definition of a U.S.R.P.H.C.

C. DEFINITION OF U.S.R.P.H.C.

We now come to the crucial definition of U.S.R.P.H.C. The failure to qualify as such will free the taxpayer from the application of the rules of *F.I.R.P.T.A.* unless the requirements of the testing period are not met. It is most important at this point to remind the reader that we

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48. Treas. Reg., s. 1.897-1(d)(3)(ii)(B) (1985).

49. *I.R.C.*, s. 897(c)(1)(A)(ii)(I) & (II).

are now dealing with a domestic (U.S.) corporation whose shares are held by a Canadian taxpayer, which could be an individual, a corporation, a trust, an estate or a partnership. If this domestic corporation qualifies as a U.S.R.P.H.C., its shares held by the Canadian taxpayer will be U.S.R.P.I. and their sale or exchange will trigger the application of *I.R.C.* s. 897.

In defining the U.S.R.P.H.C., one has to identify the value of all the U.S.R.P.I. held by the corporation, all the interest (other than as a mere creditor) outside the United States in real property and the value of any other assets which are used or held for use in a trade or business by the corporation. The corporation will be qualified as a U.S.R.P.H.C. if the fair market value of its U.S.R.P.I. equals or exceeds 50 % of:
1) the fair market value of its U.S.R.P.I.,
2) the fair market value of its interest (other than as a creditor) in real property located outside the U.S., plus
3) any other of its assets which are used or held for use in a trade or business.

An example might be appropriate at this point. Let's suppose that a Canadian taxpayer called Amy owns all the shares of U.S. corp., a corporation formed under the laws of Florida. U.S. corp. owns a piece of land in Miami worth $100 000 and a cottage in Québec city worth $80 000. Amy sells the shares of this domestic corporation in 1985. Since Amy was not present in the United States for a period of 183 days or more in 1985, the gain realized on the sale of those shares will not be subject to U.S. tax unless it is determined that the shares constitute a U.S.R.P.I. In this example, since the value of the real estate located in the United States ($100 000) exceeds 50 % of the value of all the real property held by the corporation ($180 000), the corporation will be a U.S.R.P.H.C. Thus, since the U.S. corp. is a U.S.R.P.H.C. as well as a domestic corporation the shares of which are held by a non-resident alien individual, the gain will be taxable under *I.R.C.* s. 897.

It is interesting to note that in this calculation, the "fair market value" refers to the gross value (willing buyer — willing seller) reduced by the outstanding balance of debt that are:
a) secured by a mortgage or other security interest in the property that is valid and enforceable under the law of the jurisdiction in which the property is located,[50] and
b) either:
   (i) incurred to acquire the property, or
   (ii) otherwise incurred in direct connection with the property, such as property tax liens upon real property or debts incurred to maintain or improve the property.[51]

50. Treas. Reg., s. 1.897-1(o)(2)(iii) (1985).
51. Before those regulations were enacted, authors expressed the view that the fair

In our previous example, if U.S. corp. had contracted a mortgaged loan of $25 000 on the purchase of the land in Miami, the sale of U.S. corp.'s shares would not trigger the application of *I.R.C.* s. 897 since the corporation would not then qualify as a U.S.R.P.H.C. In effect, the value of its U.S.R.P.I. ($100 000 − $25 000 = $75 000) would be lower than 50 % of the value of all the real property held by the corporation ($75 000 + $80 000).

As one could easily have imagined it, an anti-abuse rule was enacted in order to prevent debt from reducing the fair market value of the property when the debt was entered into with the principal purpose of avoiding the provisions of *I.R.C.* s. 897.[52]

An interest in real property includes also an option to buy such interest. Let's assume that U.S. corp. owns, in addition to the land in Miami (without mortgage) and the cottage in Québec, an option to buy a summer house in Baton Rouge, Louisiana. The option gives the right to buy the property at a price of $90 000 but the fair market value of the house is $100 000. The value of that option ($10 000) will affect the calculation as follows:

F.M.V. of U.S.R.P.I. = $110 000 exceeds 50 % of

$$\begin{array}{r} \$110\ 000 \\ + \\ \underline{\$\ \ 80\ 000} \\ \$190\ 000 \end{array}$$

As we can see, in this example, the value of the option did not influence the qualification of the corporation. However, let us assume that the land in Florida is encumbered by a $25 000 mortgage. Without taking into account the option, the corporation will not be a U.S.R.P.H.C. because the value of its U.S.R.P.I. ($75 000) is lower than the total value of its real property interest ($75 000 + $80 000). On the other hand, when we take into account the value of the option, the corporation becomes a U.S.R.P.H.C. ($75 000 + $10 000 exceeds 50 % of $85 000 + $80 000).

The sale of U.S. corp.'s shares by Amy will then trigger the application of *I.R.C.* s. 897 even though the option is never exercised by U.S. corp. In these circumstances, Amy would generally have to wait five years after the expiration of the option to sell the shares without being taxed in the United States. It is interesting to note that, in this example, the option should have been acquired by Amy herself or by another Canadian corporation controlled by Amy with the result that U.S. corp. would

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market value will "in all likelyhood be determined by reference to a gross market value without reduction for any liability such as mortgage attaching to property"; see: FEDER, PARKER, *supra* note 36, at 555.

52. Treas. Reg., s. 1.897-1(o)(2)(iv) (1985).

not have become a U.S.R.P.H.C. In effect, even though the option constitutes a U.S.R.P.I. for Amy or the new corporation that acquires it, it has no bearing on the qualification of U.S. corp.

This reasoning may apply also in cases where U.S. corp. is not a U.S.R.P.H.C. and wants to acquire another real property in the United States which could then render U.S. corp a U.S.R.P.H.C. This real estate in the United States should then be acquired by another corporation not controlled by U.S. corp. for reasons that we will analyze later on.

As we mentioned earlier, in the determination of the fair market value of the property, the debt attached to that property is not taken into account. This position taken by the regulations seems in conflict with the language of the statute in that *I.R.C.* s. 897(c)(2) deals with the fair market value of the property whereas the regulations use the concept of "gross value". This result will allow a great deal of tax planning in acquiring a U.S.R.P.I. For instance, let us assume that U.S. corp. controlled by Amy has a \$500 000 surplus and wants to invest it in the real estate business in Canada and in the United States. In order to avoid the qualification of U.S.R.P.H.C., it is important to keep the fair market value (as defined by the regulations) of the real property located in the United States as low as possible and to do just the opposite for the Canadian real estate. U.S. corp. should then buy U.S. real estate worth \$450 000 by paying \$50 000 cash and borrowing the remainder and mortgaging the property; U.S. corp. could then use the \$450 000 that it still has in order to buy the real property in Canada.

However, this scheme can prove to be dangerous when the property will be held for a substantial number of years. In effect, through the years, the amount of the mortgage will go decreasing which will produce an increase in the "fair market value" of the property and then may inadvertently make the corporation a U.S.R.P.H.C. Also, the natural value of the building is likely to increase due to a number of factors. For instance, if the city undergoes a major face-lift in the area where the real property is located or if an oil well is discovered at proximity, the sudden increase in value may prove very costly to the shareholders of that corporation. Obviously, this major boost in value will be welcome but one cannot forget that the U.S.R.P.H.C. taint is there for five years minimum (unless otherwise excluded) and that the gain on the shares of this domestic corporation will be subject to U.S. tax even though part of the gain is caused by an increase in value in the real property located in Canada.

Another interesting game can be played with the use of assets used or held for use in a trade or business of the corporation. As we mentioned earlier, the value of those assets will help the corporation for not qualifying as a U.S.R.P.H.C. But, what is exactly an asset that is used or held for use in a trade or business? According to the regulations, it includes, inter alia,[53]

53. Treas. Reg., s. 1-897-1(f) (1985).

— stock in trade or inventory primarily for sale to customers in the ordinary course of its trade or business,
— depreciable property used or held for use in a trade or business,
— livestock held or used in a trade or business,
— goodwill and going concern value, patents, inventions . . . and similar intangible property if used or held for use in the entity's trade or business,
— cash, stock, securities, receivables of all kinds, options or contracts to acquire any of the foregoing . . . but only to the extent that such assets are used or held for use in the corporation's trade or business and do not constitute U.S.R.P.I.

In this latter case, a safe harbour rule[54] has been set at 5 % of the fair market value of the assets used or held for use in the trade or business. The amount of cash or securities held by the corporation, even though it exceeds the safe harbour limit, might still qualify as asset used or held for use in a trade or business if the corporation can justify that it is required for present needs of the business (such as for a seasonal business) or if it is required by law to hold substantial reserves. However, the regulations seem to take the position that funds invested in securities to provide for future expansion into a new trade or business do not qualify. On the other hand, it would seem that if the corporation envisages the purchase of a major asset, it could argue that the securities are needed as collateral on the loan. In this case, let us assume that this major asset is a piece of land in Miami. The fair market value of this property will then be affected by the mortgage on the land and also we will take into account the value of the securities as asset used or held for use in a trade or business in the determination of the U.S.R.P.H.C. The securities offer then a sort of double advantage since it may help in the obtention of a higher mortgage and also it affects the second part of the computation in the determination of the U.S.R.P.H.C.

Now that we have analyzed the impact of real estate held directly by the individual and by a domestic corporation, let us add a few complications.

Let us assume that Amy, a Canadian resident and non-resident alien of the United States, holds all the shares of U.S. corp. which in turns owns all the shares of Canco (a Canadian corporation). Canco owns a piece of land in Miami. What are the tax consequences if U.S. corp. sells the shares of Canco? Is Canco a U.S.R.P.H.C.? Yes because 100 % of its assets consist of a piece of land located in the United States which is a U.S.R.P.I. However, since Canco is not a domestic corporation, the sale of its shares will not trigger the application of *I.R.C.* s. 897 because

54. Treas. Reg., s. 1-897-1(f)(3)(i) (1985).

these shares are not a U.S.R.P.I. Also, in this situation, the shares are not held by a non-resident alien individual nor by a foreign corporation. U.S. corp. will nevertheless have to include the gain in its income according to the normal rules of taxation.

However, should Amy sell her shares of U.S. corp., the result would be totally different. In effect, U.S. corp. is a domestic corporation. Is it also a U.S.R.P.H.C.? It will qualify as such if, absent assets used or held for use in a trade or business, 50 % or more of its assets consists of U.S.R.P.I. Is the holding by U.S. corp. of shares of Canco a U.S.R.P.I.? The first answer that comes to mind is negative since Canco is not a domestic corporation. However, in order to avoid this type of problem, *I.R.C.* s. 897(c)(4)(A) allows shares held in a foreign corporation to be a U.S.R.P.I. only for the purposes of determining whether a corporation (U.S. corp.) is a U.S.R.P.H.C. In this situation, since the shares of Canco will be deemed to be U.S.R.P.I. for purposes of determining whether U.S. corp. is a U.S.R.P.H.C. because U.S. corp. has an interest in a corporation (foreign or domestic) and the corporation (Canco) is a U.S.R.P.H.C., then the shares of U.S. corp. will be a U.S.R.P.I., thus triggering the application of *I.R.C.* s. 897 on their sale or exchange.

One should also not forget that although the shares of Canco are not U.S.R.P.I. for the general purpose of *I.R.C.* s. 897, the sale by Canco of the real estate in the United States is a sale of a U.S.R.P.I., thus taxable under *I.R.C.* s. 897.

In a similar situation where the real property is held by Canco, whose shares are held in a proportion of 60 % by U.S. corp. (wholly owned by Amy) and 40 % by Florida corp. (unrelated to any of the parties), then the calculation of the interest held by U.S. corp. will be made in accordance with *I.R.C.* s. 897(5). In this situation, since U.S. corp. owns 50 % or more of the shares of Canco, the fair market value of the U.S.R.P.I. held by U.S. corp. will be determined by the value of each asset of Canco, 60 % of which is attributable to U.S. corp. in the determination of the U.S.R.P.H.C.[55] However, should U.S. corp. own less than 50 % of the shares of Canco, the value of the assets of Canco will not be attributed to U.S. corp. and U.S. corp. will include in the calculation (in the determination as to whether or not U.S. corp. is a U.S.R.P.H.C.) the value of the shares of Canco only if Canco is a U.S. R.P.H.C.

Let us illustrate this concept by an example with Canco owned by Florida corp. (40 %) and U.S. corp. (60 %). The latter is wholly owned by Amy from Canada. Canco owns real estate in Canada worth \$2 million and real estate in Miami worth \$3 million. Canco is then a

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55. When the asset is held by a partnership, trust or estate, the asset shall be deemed to be held proportionately by its partners or beneficiaries regardless of the percentage of interest owned by the partner or the beneficiary. *I.R.C.*, s. 897(c)(4)(B).

U.S.R.P.H.C. If U.S. corp. holds no real property but has assets used or held for use in its trade or business worth more than \$600 000, then the shares held by Amy in U.S. corp. will not be U.S.R.P.I. since U.S. corp. will not qualify as a U.S.R.P.H.C.:

60 % × \$3 000 000 = \$1.8 million does not equal or exceed 50 % of:

\$1.8 million
\+
1.2 million (60 % × \$2 M)
\+
601 000 (assets held in business)
\$3 601 000

However, if U.S. corp. only held 40 % of Canco, then only the value of those shares would be taken into account in determining whether U.S. corp. is a U.S.R.P.H.C.

In this determination, we have to evaluate the fair market value of the U.S.R.P.I. held by U.S. corp. and in doing so, we will take into account the value of the shares held in Canco. In effect, these shares qualify as a U.S.R.P.I. (through the back door of *I.R.C.* s. 897(c)(4)(A)) because Canco is a U.S.R.P.H.C. (more than 50 % of the value of its real property is located in the United States and Canco does not have any assets used or held for use in its trade or business). In this situation, the value of Canco's shares held by U.S. corp., 40 % × \$5 M = \$2 M, will be taken into account in determining whether U.S. corp. is a U.S.R.P.H.C. We then have the following result:

	F.M.V. of U.S.R.P.I. =	\$2 000 000
	equals or exceeds	
	50 % of	
	F.M.V. of U.S.R.P.I.	\$2 000 000
+		
	F.M.V. of real property located outside the U.S.	0
+		
	F.M.V. of other assets	\$ 601 000
		\$2 601 000

The difference in the result stems from the fact that the value of the shares that is used in this last example does not consider the fact that 40 % of it is attributable to real property located outside the United States whereas this fact is taken into account when U.S. corp. owns 50 % or more of the stock of Canco.

Although this result did not benefit Amy in our last example, there are situations where it could prove beneficial. For instance, if U.S. corp owns real property in the United States with a value of \$3 000 000 and also all the shares of Canco. Canco is not involved in the real estate business and operates a manufacturing plant in Montreal. Since the value of Canco's assets are attributed to U.S. corp. for the purpose of determining whether the latter is a U.S.R.P.H.C., if Canco owns assets that are worth more than $3 000 000, then U.S. corp will not qualify as a U.S.R.P.H.C. and its shares will not be U.S.R.P.I.

In determining which corporation, either Canco or U.S. corp. will be the parent or the subsidiary, absent other relevant factors, one has to realize that in our situation, had Canco been the parent and U.S. corp. the subsidiary, the shares of U.S. corp. held by Canco would trigger the application of *I.R.C.* s. 897 because the assets of the parent are not attributed back to the subsidiary.

Let us come back now to a more simple situation where all the shares of Canco are held by U.S. corp., whose shares are all held by Amy. Let us also assume that Canco is a U.S.R.P.H.C. and U.S. corp.'s only assets are the shares of Canco. Should Amy sell her shares of U.S. corp. she will be taxed in the United Stated pursuant to *I.R.C.* s. 897 as well as in Canada since she is a resident of Canada. However, the U.S. tax paid will be credited against her Canadian tax payable.

However, should U.S. corp. sell its shares of Canco, U.S. corp. will include that gain in the computation of its income for U.S. tax purposes. Also, absent a disposition of a treaty preventing this result, U.S. corp. would also be taxed in Canada pursuant to *I.T.A.* s. 115(1)(b)(iii). The tax rate applicable would be the regular rate applicable to Canadian corporations which is 46 %. Since the real property is not located in Canada, s. XIII(3)(b)(ii) and s. XIII(4) of the Canada-U.S. tax convention will prevent the double taxation.

Let us now turn the situation around and have Amy own 100 % of Canco which owns 100 % of U.S. corp. U.S. corp. owns real property in the United States. If Amy sells her shares of Canco, the gain would not be taxed in the United States since the shares of a foreign corporation do not constitute U.S.R.P.I. Nevertheless, Amy would still have to account for this gain to the Canadian tax authorities. In the event that Canco sell its shares of U.S. corp., the gain would be taxed in the United States pursuant to *I.R.C.* s. 897 as well as in Canada.

D. TREATY RULES

Section XXX(5) of the new Canada-U.S. tax convention provides that if a greater relief would have been afforded under the old treaty, any such provision of the old treaty shall apply until December 31, 1985. The old treaty provided that gain realized on the disposition of real property was taxed in the foreign country only if the taxpayer had a permanent establishment in that foreign country.[56] Accordingly, it would seem that *I.R.C.* s. 897 would not apply to a Canadian taxpayer, who does not have a permanent establishment in the United States, until 1986. Or does it?

This relief provision of the treaty is in apparent conflict with the internal law of the United States which promulgated the rules of *F.I.R.P.T.A.* Paragraph (1) of section 1125(c) of P.L. 96-499 provides:

> Except as provided in paragraph (2), after December 31, 1984 nothing in section 894(a) or 7852(d) of the Internal Revenue Code of 1954 or in any other provision of law shall be treated as requiring, by reason of any treaty obligation of the United States, an exemption from (or reduction of) any tax imposed by section 871 or 882 of such Code on a gain described in s. 897 of such Code.
>
> Paragraph 2 of this section goes on:
>
> A) If any treaty (hereinafter in this paragraph referred to as the "old treaty") is renegociated to resolve conflicts between such treaty and the provisions of section 897 of the Internal Revenue Code of 1954, and
>
> B) the new treaty is signed before January 1, 1985,
>
> then paragraph (1) shall be applied with respect to obligations under the old treaty by substituting for "December 31, 1984" the date (not later than 2 years after the new treaty was signed) specified in the new treaty (or accompanying exchange of notes).

By its internal law, the United States contradicts the terms of the treaty negociated with Canada. Does that mean that the American taxpayer investing in Canada can take advantage of the old treaty until the end of 1985 whereas the Canadian taxpayer cannot?

Two arguments can be made in favour of the Canadian taxpayer. First, the Canada-U.S. tax convention was signed on September 26, 1980 and instruments of ratification were exchanged on August 16, 1984. Section 1125(2)(B) indicates that when a treaty is signed before 1985, this treaty can override *I.R.C.* s. 897 for a maximum of two years after the treaty was signed. We can definitely discover an intention on the part of the U.S. government to allow a treaty to override the terms of *F.I.R.P.T.A.* for a period not exceeding December 31, 1986. Consequently, it would not seem so abnormal to have the Canada-U.S. tax convention to override it until the end of 1985. Also, could the word "signed" in (B) be interpreted as referring to the date where the instruments of ratification were exchanged? This position would be hard to defend because of the clear language of the statute.

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56. S. VIII of the Convention and protocol between Canada and the United States of America for the avoidance of double taxation and the prevention of fiscal evasion in the case of income taxes, signed at Washington, March 4, 1942, and made applicable as and from January 1, 1941; see chap. 21, 7 Georges VI.

However, a better argument would be that since the treaty came into force after the application date of *F.I.R.P.T.A.*,[57] the treaty provisions have an amending effect over the internal law and in case of conflict, the treaty should prevail. This position[58] is reinforced by the technical explanation of the convention where it is indicated that, with respect to section XXX(5) of the treaty,

> paragraph 5 modifies the rules of paragraph 4 to allow *all* the provisions of the 1942 convention to continue to have effect for the period through the first taxable year [. . .]

Conclusion

A number of other problems are related to the holding of real property in the United States, such as reorganization of the corporation, liquidation, distribution of property to the shareholders, etc. Even though these aspects were not within the scope of this paper, one can pick up the thrust of these other provisions of the Code which can be summarize as follows: Any type of transfer from the holding corporation to another corporation or to a shareholder will not be permitted to be made tax-free if the new owner of the property will escape tax upon a future disposition.

The other problem that we have not dealt with is the method by which the tax payable will be withheld when the non-resident sells his U.S.R.P.I. The new regulations under *I.R.C.* s. 1445 are certainly complex and might even create more problems than they will solve. Only time will tell.

However, if there is one thing that we are sure of, it is that the rules of *F.I.R.P.T.A.* constitute a major element to be considered by Canadian investors and any move into the real estate business in the United States should be preceded by a careful tax analysis of the situation.

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57. *F.I.R.P.T.A.* applies to dispositions after June 18, 1980.

58. This position is shared by Boidman, "New Canada — U.S. Treaty: Effective Dates and Transitional Issues", (1984) 32 *Canadian Tax Journal* 922; see also Feder, Parker, *supra*, note 36, at 573.