I. Tax Planning for Canadian Real Property Owned by a U.S. Citizen/Resident*

** Copyright ©2024 by Mark T. Serbinski CA (Ont.), CPA (Ont.),CPA (Illinois & Florida) Mr. Serbinski is a Chartered Accountant/Chartered Professional Accountant practicing in Ontario and a partner in the firm of Serbinski Partners PC, Chartered Professional Accountants, Toronto, Ontario as well as a Certified Public Accountant licensed in Illinois and Florida, and a practitioner in the firm of Serbinski Accounting Firms, PC, Certified Public Accountants in Chicago, Illinois. Admitted to practice before the Internal Revenue Service, Mr. Serbinski practices international tax and acts as a consultant to the profession. Further information is available at https://www.serbinski.com.*

1.01 Introduction:

This memo is designed to address the estate and income tax implications of the transfer of a Canadian situs real estqte asset held by a U.S. citizen or resident, either before or after the death of the owner This memo is not designed to address the disposition of other assets owned by the US person upon their demise.

All dollar amounts referred to in this memo are presented in Canadian funds. In order to calculate the tax effect of any sale or transfer of this property, U.S. conversion must be calsulated on the basis of the rates at various dates.

Executive Summary:

Given the circumstances discussed in this article, it appears that the optimal treatment in detremining how to deal with the Canadian property would be to add Related Canadian beneficiary as legal joint tenant of the property at this time (subject to the cautions presented later). In this way, since there is no change in the beneficial ownership of the property currently, there would be no tax effect or reporting required currently in either Canada of the U.S. The related Canadian joint tenant would become the beneficial and legal owner or the property at the death of the U.S. citizen/resident's death, if he or she is the sole surviving joint tenant.

1.02 Background

Let us assume that Canadian cottage land was acquired in prior to 1971 for a nominal amount, and construction and other capital improvements totalling approximately $195,000 were made to the property over time. The property is valued at approximately $740,000 in 2024

1.03 Tax Implications of Death in Canada

Canada does not have an estate tax per se, but instead requires a decedent to deem the dispositon of all capital property held at the time of death. In the case of a non resident of Canada, this deemed dispositoin of capital property is restricted to "taxable Canadian property", or real estate and certain corporate holdings held in Canada. Since a non resident of Canada who previously resided in Canada would have declared the deemed disposition of all other capital property held at the time of departure from Canada, that other property does not form part of the Canadian estate and is not subject to deemed disposition.

In the case of a U.S. citizen resident in Canada, there would be a deemed disposition of all property held by the decedent worldwide, at fair market value, worldwide.

1.04 Capital Gains Taxation in Canada

Capital gains were not taxable in Canada before December 31, 1971 which is known as "Valuation Day" (V-Day). Any property held on Valuation Day acquired the fair market value as of that date as its "Adjusted Cost Base", for use in determining the amount of reportable capital gains for sales closing after D-Day.

A property designated as a "Principal Residence" in Canada is fully exempt from Canadian capital gains taxation. A family could have two principal residences until 1982, when that rule was repealed and required a family to designate only one property as a principal residence. Where a property is designated as a principal resicence for any number of years it is owned, the exempt portion of the capital gain is calculated using the following formula:

Exempt gain = Number of years designated as principal residence/ number of years owned.

Whether a principal residence exemption applied or not, once a gross capital gain was determined, a general capital gains exemption of $100,000 was available until February 22, 1994. Where a property was not sold, many people filed an election on form T664 to "crystalize" the exemtion and effectively to increase their ACB by the exemption amount. The filing of form T664 would have been required by February 22, 1996 to be considered effective.

Therefore it would be prudent to determine whether form T664 was filed for the Canadian property, since it may have changed the ACB of this property. If this election was not timely filed, it is no longer available.

After all of the above exemptions, the "Taxable Capital Gain" is determined by dividing the gross capital gain in half. (The capital gains inclusion rate was 50% except for dispositions in 1988 & 1999 when it was 2/3, and in 1990 through 1999 when it as 75%). The Taxable Capital Gain is added to other income for the year of disposition and tax is calculated at regular graduated tax rates. Taxable Capital Gain is added to other income for the year of disposition and tax is calculated at regular graduated tax rates.

1.05 U.S. Effect of Capital Gains in Canada.

Where a U.S. person realizes a capital gain in Canada, the gain is included in U.S. taxable income and taxed at the capital gains rate in effect for that Taxpayer. If tax was payable in Canada then a foreign tax credit can be applied on the U.S. return to prevent double taxation.

Deemed dispositions determined under Canadian law, and elections made under Canadian law to accelerate the recognition of a gain are not recognized in the U.S. Therefore, in the case of a "crystallization" elected in Canada, the original basis of the property is maintained for U.S. purposes, regardless of the treatment in Canada.

However, pursuant to Article XIII(7) of the Canada U.S. Income Tax Convention (Treaty), a person who is deemed to have realized a capital gain in Canada may elect to recognize that gain in the U.S. This is often done to coordinate the foreign tax credits available in the case of a taxable gain in Canada. However, since no tax would have been paid in Canada on the "crystallization" election discussed previously, it is unlikely that a U.S. person would make the election under Article XIII(7) of the Treaty.

1.06 Determining the Difference Between Legal and Beneficial Ownership of Canadian Property.

In Canada, it is important to distinguish the difference between "legal ownership" (which is reflected on a property deed as registered, and "beneficial ownership" (which refers to an interest in the financial or economic component of the property.)

It is possible to have a person who holds legal and beneficial ownership to add a "legal" owner to the deed of the property while retaining the beneficial ownership. In such a case a joint tennancy is established between the legal owners and the beneficial owner.

Pursuant to Pecore v. Pecore, 2007 SCC 17 (CanLII), [2007] 1 SCR 795, it has been held that the adding of a legal owner results in the creation of a de facto "bare trust" relationship, where the legal owner holds his interest in the property as a bare trustee for the benefit of the beneficial owner. The court held that in the absence of proof, the presumption of a resulting trust is a general rule for gratuitous transfers and the onus is placed on the transferee to show that a gift was intended. For there to be a valid gift to a single party, there must be evidence in writing to form a gift.

Accordingly there is no taxable event on the addition a legal owner to the title of a property. Upon the death of either joint tenant, the remaining owner would become the legal and beneficial owner, and in the event of the beneficial owners death, there would be a taxable event where the beneficial interest in the property would be deemed to be disposed of at fair market value as of the date of death.

1.07 Downside of Adding a Legal Owner to Real Property

The following are potential negative factors to consider when adding a joint tenant to a property:

1. The act of adding a legal owner is not revokable, and a change in a will connot reverse the transfer;
2. The fiscal condition of all joint tenants can affect the equity in the property. If a joint tenant is subject to litigation or any judgement, the property may be at risk;It is important to specify that there is no intention to gift the property, since a non arms length gift would give rise to a taxable event.
3. Adding a joint tenant to a property may also have the unintended effect of having the property revert to the original beneficial owner in the event of the death of the legal joint tenant.

1.08 Estate Planning Alternatives Concerning the Canadian Real Property

On the assumption that the beneficial and legal owner of a Canadian property wishes to convey the property to a related party either before or after death, the following are the available alternatives related to the transfer of the property:

(a) Gift the Property to the Related Canadian Beneficiary

Transfer of the property to the related Canadian beneficiary by way of gift during the lifetime of the U.S. person. In this case, for Canadian purposes, the property would be deemed to have been sold to the related Canadian beneficiary for fair market value, and the U.S. person would pay tax on the taxable capital gain at the time of transfer. (Since this would be considered a gift to the related Canadian beneficiary, his ACB of the property would be the originally determined ACB as determined earlier in this memo.) This would result in the double taxation of a majority of the capital gain upon the beneficiary's eventual sale of the property (or on his demise).

> **U.S. Effect:** *A U.S. gift tax return would need to be filed by the U.S. person, but no tax would likely be currently payable, since the amount of the gift would simply reduce the lifetime estate tax unified credit. The unified credit shields $12,060,000 of gross estate now until 2026, when this number may drop to about $6,000,000.*

(b) Sell the Property to the Related Canadian Beneficiary

Sale of the property to the related Canadian beneficiary at fair market value during the lifetime of the U.S. person. This would result in the same tax on the capital gain to fair market value, but would provide the related Canadian beneficiary with an increased ACB, this eliminating double taxation. (To give effect to this, the U.S. person could take back a mortgage which could be forgiven in the will.)

> **U.S. Effect:** *The gain would be reportable in the U.S. but a foreign tax credit for the Canadian tax paid would reduce or eliminate any tax in the U.S.*

(c) Leave the Property to the Related Canadian Beneficary in the Will

Taking no action now, but leaving the property to the related Canadian beneficiary in the U.S. person's will. This would result in Canadian capital gains tax being payable in the final return of the U.S. person upon death due to the deemed disposition of the property. Since the property would transfer to the related Canadian beneficiary from the estate, the related Canadian beneficiary would inherit the property with an ACB equal to fair market value at the date of the U.S. person's death, but probate fees would be payable. In Ontario, probate fees are 1.5% of the value of Ontario situs assets in excess of $50,000, or $10,500 if the property value is $750,000 as of the date of death.

U.S. Effect: *Although tax would be payable in Canada on the deemed disposition of the property, under current U.S. law the property receives a "stepped up basis", which means that the decedent's estate does not pay tax on the unrealized gain until death, and the beneficiary inherits the property with a basis stepped up tax free to that fair market value*

(d) Add the Related Canadian Beneficiary to the Legal Title of the Property

Add the related Canadian beneficiary to the title of the Canadian property as a legal, but not a beneficial owner. This has no tax effect in Canada since there is no change in beneficial ownership, and since a de facto bare trustee relationship is established. Upon the death of the U.S. person, the related Canadian beneficiary would become the legal and beneficial owner of the property. No probate fees would be payable since Related Canadian beneficiary would already be on title, and the estate of the U.S. person would pay capital gains tax in Canada on the deemed disposition of the beneficial interest on death. This would result in the related Canadian beneficiary obtaining the property with an ACB equal to the fair market value at the U.S. person's death.

U.S. Effect: *Although tax would be payable in Canada on the deemed disposition of the property, under current U.S. law the property would be re-valued with a "stepped up basis", which means that the decedent's estate does not pay tax on the unrealized gain until death, and the beneficiary inherits the property with a basis stepped up tax free to that fair market value.*
Further, since there would be no change in the beneficial ownership at the time Related Canadian beneficiary is added to the title, and since there is no gift at that time, there would be no reportable transaction in the U.S. until the death of the U.S. person.

Given that the payment of tax at a later date is preferable to the payment of tax today, and given that no probate fees would be payable on the transfer to the related Canadian beneficiary, it is likely that this final alternative would be preferable.

This summary has been designed to provide a concise overview of only the subjects addressed, and may not be complete. Reference should be made to original legislation prior to acting on any matter, and professional advice should also be obtained.

Please contact us for a confidential review of your individual situation. To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any tax advice contained in the body of this document was not intended or written to be used, and cannot be used, by the recipient (a) for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions and (b) for the purpose of promoting, marketing, or recommending any tax-related matters addressed within to another party.

Mark T. Serbinski CA, CPA