# Single-Purpose Reprieve

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Holding U.S. vacation properties in a so-called "single-purpose corporation" is a long-standing strategy to avoid U.S. estate taxes and probate. That's because, if certain conditions are met, CanRev will not impose tax penalties based on "shareholder benefits" which generally apply where personal-use assets are held in a corporation.

In June, the CRA announced a clamp-down on so-called "single-purpose corporations" to hold U.S. vacation properties; the policy was to kick-in on the date of announcement – June 23rd (see Single-purpose Corporations Kaput, in the July issue of the TaxLetter).

However, late last month, CanRev announced that the restrictions would be delayed until January 1st, 2005. The announcement, which was made at the annual Canadian Tax Foundation Conference, has received very little press. Even some tax advisors are unaware of the extension.

Based on the June announcement, starting January 1, 2005 the single-purpose corporation policy will no longer apply:

- for any property acquired by a single-purpose corporation; or
- if a person acquires shares of a single-purpose corporation unless such share acquisition is the result of the death of the individual's spouse or common-law partner.

So if you hold a vacation property personally, or are about to buy one, you should consider making sure that it is held by a single-purpose corporation by year end. If this is done, there should be "grandfathering" available so that the strategy will be viable after the end of this year.

Note: While it is quite possible that there could be changes, the June announcement itself stated that the pre-existing administrative policy (i.e., "grandfathered" status) will continue to apply to those arrangements that were in place at the time of the announcement until the earlier of:

- the sale (or other disposition) of the particular U.S.-based real estate by the single-purpose corporation; or
- a sale (or other disposition) of the shares of the single-purpose corporation, other than a transfer of such shares to the shareholder's spouse or common-law partner as a result of the death of the shareholder.

Since the single-purpose corporation concession was first announced nearly a quarter of a century ago (in the Revenue Canada Round Table at the 1980 Canadian Tax Foundation annual conference), there has been a growing list of strings attached to single-purpose corporation status. For example, CCH's Canada Estate Planning Guide lists the following hurdles that must be passed before single-purpose corporation status will be available.

1. The corporation must be a "Canadian corporation" within the meaning of the Income Tax Act.
2. The corporation's only objective must be the holding of a residential real property in the United States for personal use or enjoyment of the shareholder.
3. The shares of the corporation must be held by an individual and/or persons (other than a corporation) related to the individual.
4. The only transactions of the corporation must relate to its objective of holding property in the United States for the personal use or enjoyment of the shareholder. The property may not be used occasionally as a rental property. The corporation may not own more than one property.

5. The shareholder must be charged with all the operating expenses of the property by the corporation, with the result that the corporation would show no profit or loss with respect to the property on any of its income tax returns. The shareholder must not pay rent.
6. The corporation must acquire the property with funds provided solely by the shareholder. Inter-company loans cannot be used. In the case of multiple shareholders, each shareholder must contribute a pro-rata amount as equity or as a loan.
7. The property must be acquired by the corporation on a fully taxable basis, that is, without the use of any "rollover". [This means that any appreciation of the property – as measured in Canadian funds - will be taxable on the transfer of the vacation property into the corporation.]

Is it possible that the single-purpose corporation tax break will be extended further? When the extension was announced, it was stated that there would be ongoing "consultations". However, CRA officials maintain that these will pertain to issues when the restrictions come into effect - not further extensions. This could include specific hardship issues, particularly the recent hurricanes in Florida, as well as the extent of grandfathering and whether there will be a "sunset clause" on the application of the old single-purpose corporation policy.

No doubt, a big issue will be the amount of the taxable benefit assessed for non-grandfathered corporations. One of the leading court cases in the area (Youngman v. The Queen) sanctioned a benefit based on the "cost of capital" used to build a home – i.e., an "interest factor" was applied to the funds used by the company to build the home. It would follow that an offset should be allowed for shareholders' funds that are injected into the corporation as interest-free loans. However, murky issues remain, such as whether there would be a benefit if the vacation property has gone up in value. Hopefully, the CRA will announce a relatively benign policy on taxable benefits, once a single-purpose status is no longer available.

## U.S. Estate Taxes – to be Repealed?

As many readers are aware, U.S. estate tax is to be phased out over the next few years, culminating with the repeal of estate taxes (but not U.S. gift taxes) on January 1, 2010 - an exemption of $1.5M U.S. applies through 2005, increasing to $2M U.S. between 2006 and 2008, and $3.5M U.S. in 2009; but this refers to worldwide assets. But there's a catch: there is a "sunrise" clause calling for the automatic re-enactment of estate taxes on January 1, 2011, and the reversion of the gift tax to its 2001 form, unless there is a positive act by U.S. Congress before that date. For Canadians with U.S. assets, this means that if the sunrise clause is operative, the U.S. estate tax will spring back to life, with a credit only for the first U.S. $1M of assets.

Besides a change to a democratic government, even if the Republicans remain in power, it's possible that there could be a change of heart, for example, due to pressure to finance the war on terrorism. While it is too early to make any firm predictions, the farther we get into the decade, the more it seems that U.S. estate taxes may spring back to life in some form or other.

## Beware of Warts

I should note that, in the past, there has been much commentary on U.S. issues arising from single-purpose corporations. Some tax advisors have even suggested that the sum total of CanRev's requirements may cause fundamental problems from a U.S. tax standpoint: if the strategy was put under a microscope by the I.R.S., it may not work.

In addition, because the property is held in a corporation, there could be complications if it has appreciated in value. For one thing, the single-purpose corporation will not be eligible for the 15% U.S. tax rate on capital gains, which applies to individuals - but not corporations. Instead, there could be U.S. federal corporate taxes of up to 35%, plus applicable state taxes (although they would be creditable against Canadian corporate taxes up to applicable limits). There could also be Canadian tax complications when the shares of the single-purpose corporation pass to another generation on death (or otherwise). The reason is that the shares of the corporation are treated as having been sold at their market value – which presumably reflects the appreciation of the vacation property. The result is that there is an increase of the cost base of the shares to beneficiaries; however, there is no effect on the tax cost of the underlying property, thus potentially leading to a tax on the same appreciation if the vacation property is sold. (Of course, principal residence status will not be available.)

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But even with all these warts, a single-purpose corporation may give you a good shot at completely avoiding the U.S. estate tax net and should be considered if you are concerned about whether the repeal will come to pass, or if your estate exceeds the exempt limits for the second half of this decade. When other U.S. estate tax strategies are closely examined, it often turns out that they either have their own set of warts, and/or are very complex and costly to implement.