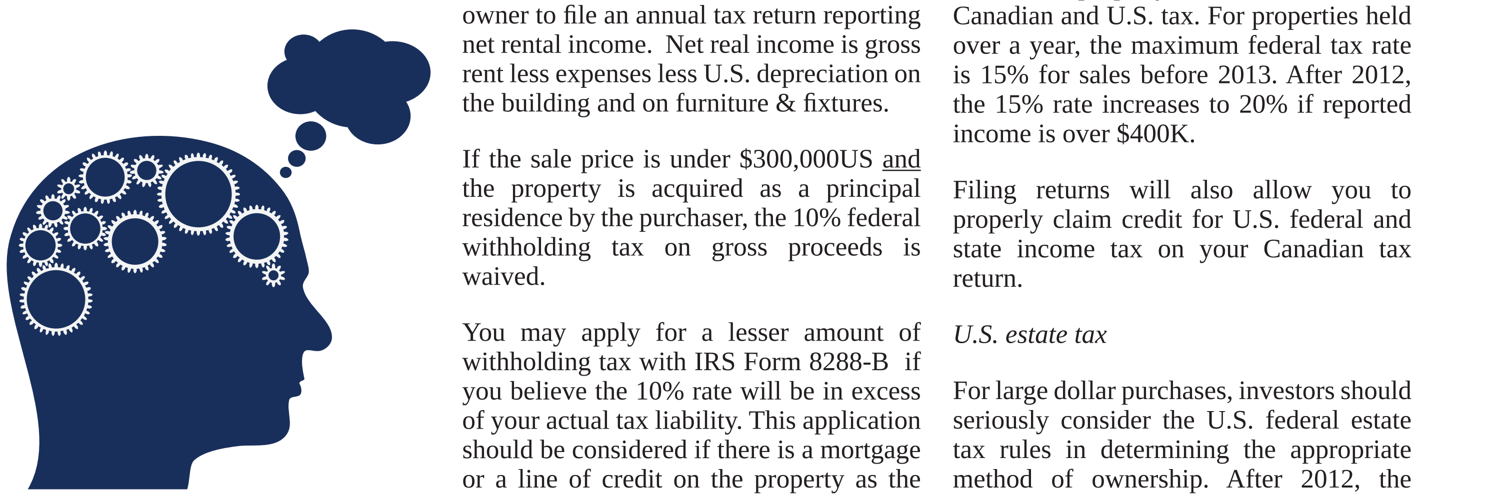
Investing in the U.S.

Even with some economic recovery, the landscape in the U.S. has made it very attractive for Canadians to purchase vacation or rental properties in the warmer climates.

Interest has increased as result of lower pricing as well as the stronger Canadian currency with anticipation of realizing significant capital gains when the market fully recovers.



Canadian businesses wishing to expand into the U.S. marketplace should be aware of the income tax implications with respect to deriving income in the U.S. and repatriating profits back to Canada.

The U.S. like Canada, have specific tax rules with respect to inbound investing by non-U.S. persons. Often the simple things to be in compliance are not provided to the investor as part of the marketing process causing unnecessary grief for the unwary.

Rental and sale of U.S. real estate

Withholding tax on rental and sale

Canadians who intend to rent their U.S. property are subject to a 30% U.S. withholding tax on the gross rent.

A waiver from withholding is available by providing the withholding agent with IRS Form W8-ECI. The W8-ECI requires an individual taxpayer's identification number ("ITIN") for individual investors. Until a properly completed W8-ECI is accepted by the agent, the agent may still withhold.

The completion of the W8-ECI obligates the owner to file an annual tax return reporting net rental income. Net real income is gross rent less expenses less U.S. depreciation on the building and on furniture & fixtures.

If the sale price is under $300,000US and the property is acquired as a principal residence by the purchaser, the 10% federal withholding tax on gross proceeds is waived.

You may apply for a lesser amount of withholding tax with IRS Form 8288-B if you believe the 10% rate will be in excess of your actual tax liability. This application should be considered if there is a mortgage or a line of credit on the property as the 10% will have to come out of your pocket.

ITIN W-7 applications

To ensure that the W-7 is completed accurately, it is recommended that you engage an IRS Acceptance Agent practicing in your area to assist in the completion of the W-7 and to attach a Certificate of Accuracy.

Filing tax returns

Without the W8-ECI, you may still elect to file a tax return and claim credit for tax withheld. The election covers all rental properties. Once you elect, it is binding until you revoke the election.

Filing the return on a timely basis will allow you to utilize accumulated losses against net rental income and on capital gains from the sale of the property.

With joint ownership or tenants in common, each party must complete their own W-7 and tax returns.

Capital gains realized on the sale of any U.S. real property interest will attract Canadian and U.S. tax. For properties held over a year, the maximum federal tax rate is 15% for sales before 2013. After 2012, the 15% rate increases to 20% if reported income is over $400K.

Filing returns will also allow you to properly claim credit for U.S. federal and state income tax on your Canadian tax return.

U.S. estate tax

For large dollar purchases, investors should seriously consider the U.S. federal estate tax rules in determining the appropriate method of ownership. After 2012, the marginal estate tax rate becomes 40% after $1M of taxable value is attained.

Carrying on business in the U.S.

Often first venturing into the U.S. marketplace is due to selling or providing a service to a U.S. entity. On many occasions, the U.S. payor may put a hold on paying your bill because they are concerned that they will be subject to some form of IRS withholding. Without an appropriate waiver form and identification number, your payment will be delayed. At this stage, the compliance issues begin.

Protective returns

If you or your Canadian corporation are doing business in the U.S., depending on the nature and degree of activity, the Canada/U.S. tax treaty may determine that your U.S. business profits are not subject to U.S. tax. If this is the case, you should consider filing a protective U.S. tax return on a timely basis in order to deduct allowable expenses against the gross U.S. source income if the IRS does not agree with the your treaty-based position. Without the protective return, the loss of deductions will result in a significant amount of additional tax that may not be fully creditable in Canada.

Individual states do not follow the tax treaty. They look to their nexus rules to determine if you are subject to income tax or a minimum franchise tax. You could be operating in more than one state and be subject to sales/use tax.

No treaty protection

If a protective filing does not apply, using your Canadian corporation ("Canco") as a U.S. branch operation may result in a more complicated U.S. corporate tax return including branch interest or branch profits tax. Although start-up losses may generally be used by Canco, later incorporating the branch operation may result in unanticipated U.S. and Canadian tax implications, especially if there is goodwill and unrealized appreciation inherent in the U.S. assets.

U.S. corporations

If you incorporate a U.S. corporation, it is generally preferable to have Canco make the investment to lower your personal tax on dividends received from Canco that indirectly arose from the U.S. after-tax profits. U.S. federal estate tax will not apply because you personally do not hold the U.S. shares.

You need to address both federal and state taxation as well as the tax implications on repatriating funds either through dividends or say management fees to Canada. Transfer pricing may also be an issue if you anticipate inter-company purchases or even a licensing or royalty arrangement. If you provide personal services in the U.S., that has to be addressed as well.

> "Investing or carrying on business in the U.S. requires pre-planning to avoid costly mistakes"

Canada has specific foreign reporting forms that may further complicate your Canadian tax compliance. If your U.S. corporation is a controlled-foreign affiliate, the foreign accrual property income rules ("FAPI") in our Income Tax Act may result in an unanticipated prepayment of tax on U.S. passive income.

If mind and management of the U.S. corporation is in Canada, there is the possibility that those U.S. business profits could be subject to both U.S. and Canadian tax unless a treaty exemption applies. Here it is imperative that the appropriate organizational structure be implemented to avoid double taxation and/or mismatching of foreign tax credits.

U.S. corporations may include a C or a LLC corporation. Those living in the U.S. generally use a LLC because income is allocated to the member or shareholder as opposed to the C corporation, where there is first corporate tax and then personal tax when retained earnings are distributed to the shareholder.

Many Canadians have incorporated LLCs without investigating the Canadian tax treatment. Canada does not recognize the LLC as a flow-through because the LLC is not a taxable U.S. entity unless a special election is made which can further complicate matters. Unless income and distributions are made in the same taxation year from the LLC, there will likely be double taxation and mismatching of foreign tax credits. With U.S. partners, you may consider utilizing a C corporation having an interest in one or more LLCs for the U.S. partners.

Mistakes on compliance can be costly!

U.S. tax compliance is an added administrative cost of investing in the U.S. Keep it simple unless you require a more complex structure for asset and limited liability protection. With an imperfect structure, your after-tax cash flow can be compromised!■

Larry Stolberg CA, CPA, CFP

Disclaimer to readers: Contact your professional advisor prior to implementing any of the outlined strategies.