Single-Purpose Corporations May Not Avoid US Estate Tax

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PRÉCIS

Les sociétés à but unique ont constitué un moyen privilégié d'éviter l'impôt successoral américain sur les résidences de vacances détenues par des Canadiens. Toutefois, cette stratégie pourrait échouer si la société canadienne est exploitée conformément aux lignes directrices de Revenu Canada visant à éviter qu'un avantage soit conféré à un actionnaire.

La loi fiscale américaine examine le fond d'une opération plutôt que sa forme. En vertu de cette théorie, une société à but unique pourrait ne pas pouvoir éviter l'impôt successoral américain pour trois raisons distinctes.

D'abord, la loi fiscale américaine pourrait ne pas tenir compte des sociétés sans activité ou objet commercial précis. Une société qui observe les exigences de Revenu Canada sur les sociétés à but unique pourrait avoir une activité ou un objet commercial insuffisant pour satisfaire à cette exigence.

Deuxièmement, si tous les fardeaux et avantages de la résidence reposent essentiellement sur l'actionnaire, la loi pourrait ne pas tenir compte de la société. Puisqu'un actionnaire canadien qui satisfait aux exigences d'une société à but unique semble assumer la majeure partie des fardeaux et avantages de la résidence, l'actionnaire sera probablement considéré propriétaire de la résidence de vacances aux fins de l'impôt successoral américain.

Troisièmement, la loi pourrait faire abstraction des sociétés qui sont simplement des conduits pour leurs actionnaires. Une société à but unique pourrait être un conduit, car elle agit entièrement dans l'intérêt de son actionnaire plutôt qu'à titre indépendant.

Des dispositions précises du Internal Revenue Code posent des problèmes distincts. En vertu des articles applicables, un bien transféré à une société étrangère pourrait continuer d'être assujetti à l'impôt successoral américain si l'actionnaire conserve le droit de

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changer la jouissance du bien ou de jouir de ce bien. Ces dispositions pourraient s'appliquer à une société à but unique.

Étant donné la possibilité qu'une société à but unique ne puisse pas éviter l'impôt successoral américain, l'utilisation d'une telle société est à déconseiller. Les propriétaires de résidences de vacances aux États-Unis devraient songer à d'autres solutions telles que l'utilisation d'une dette sans recours, la vente de la résidence avant le décès ou la copropriété du bien. Le manquement à respecter les lignes directrices de Revenu Canada relative à l'avantage conféré à un actionnaire serait également une façon d'éviter l'impôt successoral américain, quoique au risque d'entraîner cet avantage au Canada.

Les particuliers qui utilisent une société à but unique disposent d'un nombre limité d'options disponibles comparativement à ceux qui n'ont pas encore pris une telle disposition.

ABSTRACT

Single-purpose corporations have been advocated as a means of avoiding the US estate tax on US vacation property owned by Canadians. This strategy may be flawed where the Canadian corporation is operated in accordance with Revenue Canada's guidelines relating to the avoidance of a shareholder benefit.

US tax law looks at the substance of a transaction rather than its form. Under this doctrine, a single-purpose corporation may fail to avoid US estate tax on three separate grounds.

First, corporations with no business purpose or activity may be ignored for US tax purposes. A corporation that complies with Revenue Canada's single-purpose corporation requirements may have insufficient business activity or purpose to meet this requirement.

Second, where the shareholder has substantially all the burdens and benefits of ownership, the corporation may be ignored. Since a Canadian shareholder satisfying the single-purpose corporation requirements appears to bear the predominant share of the burdens and benefits of ownership, the shareholder would likely be considered the owner of the vacation property for US estate tax purposes.

Third, corporations that are merely conduits for their shareholders may be ignored. A single-purpose corporation may be a conduit because it acts entirely in its shareholder's interest rather than in an independent capacity.

Separate concerns arise under specific provisions of the Internal Revenue Code. Under the applicable sections, property transferred to a foreign corporation may continue to be subject to US estate tax if the shareholder retains a power to change the beneficial enjoyment of the property or the right to enjoy the property. These provisions may apply to a single-purpose corporation.

Given the possibility that a single-purpose corporation will not avoid US estate tax, use of such a corporation is inadvisable. Owners of US vacation property should consider alternatives such as the use of non-recourse debt, the sale of the residence before death, or the joint ownership of property. Failure to comply with Revenue Canada's shareholder benefit policy also would result in avoidance of the US estate tax, although at the risk of incurring a shareholder benefit in Canada.

Individuals currently using a single-purpose corporation have more limited options available than those who have not yet set up such an arrangement.

INTRODUCTION

Before November 1988, US estate tax was levied at rates ranging from 6 to 30 percent on the US property of persons who were neither US residents nor US citizens.[1] Those persons now pay the same estate tax rates as US citizens, which can exceed 55 percent.[2] Some relief from the US estate tax is available to US citizens and residents because US citizens and residents are entitled to a credit that offsets tax on the first $600,000 of property and because property transferred to the taxpayer's spouse is not subject to the estate tax.[3] However, property transferred to a spouse may not be exempt if the spouse is not a US citizen or resident.[4] Furthermore, if the decedent is not a US resident or citizen, the credit offsetting the tax on the first $600,000 of property is reduced so that only the first $60,000 of property is exempt from estate tax.[5] Canada, unlike some countries, has no estate tax treaty to provide relief from these discriminatory provisions.[6] When the US estate tax is combined with the deemed disposition of capital property upon death under the Canadian Income Tax Act,[7] the total tax rate on US property can exceed 70 percent.

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[1] Former section 2101(d) of the Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

[2] IRC sections 2101 and 2001(c)(2) and (3).

[3] IRC sections 2010(a) and 2056(a).

[4] IRC sections 2056(d) and 2056A.

[5] IRC section 2102(c)(1).

[6] The former Convention Between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on the Estates of Deceased Persons, signed at Washington, DC on February 17, 1961, ceased to have effect for estates of persons deceased after December 31, 1984 pursuant to article XXX(8) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocol signed at Ottawa on June 14, 1983 and the protocol signed at Washington on March 28, 1984.

[7] RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act").

Because the US estate tax is not levied on the shares of a foreign corporation held by a person who is neither a US citizen nor a US resident,[8] an extremely popular solution to this problem has been to organize a Canadian private corporation to hold a US vacation home. Although this strategy at first glance seems effective, it likely does not eliminate the potential liability for US estate tax.

A Canadian tax problem arises with the use of a corporation to hold the US residence because if the corporation owns the home, but the shareholder has control and enjoyment of it, the shareholder might receive a taxable shareholder benefit under the Act, even if the shareholder pays the expenses of operating the home.[9] An informal concession by Revenue Canada (herein referred to as "the shareholder benefit concession") arising from the 1980 Canadian Tax Foundation conference (as modified by announcements made at the 1985 and 1989 conferences)[10] provides that no shareholder benefit will exist if

- the corporation's *only* objective is to hold the home for the shareholder's personal use;
- the corporation's *only* transactions relate to holding the property for the personal use of the shareholder;
- the shareholder is charged by the corporation for *all* expenses associated with the property, the corporation does not charge rent, and the corporation has no profit or loss to show on its tax returns;
- the shareholder advances or transfers *all* funds to the corporation to pay for the property;
- the individual or related parties hold the corporation's shares; and
- the corporation did not receive the property on a tax-deferred rollover.

One might reasonably ask why compliance with these requirements removes any shareholder benefit. The answer seems obvious. If these requirements are satisfied, in essence the corporation is merely holding title to the property and the shareholder is the actual owner of the property. If the shareholder, rather than the corporation, actually owned the property, there would of course be no shareholder benefit. This analysis may be how Revenue Canada resolved the shareholder benefit problem. In a recent document discussed in *Access to Canadian Income Tax*, Revenue Canada explained its position as follows:

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[8] IRC section 2104(a).

[9] See *J. Woods v. MNR*, [1985] 2 CTC 2118 (TCC).

[10] See "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 20, at 606-7; "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 49:1-32, question 14, at 49:8; and "Revenue Canada Round Table," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Tax Conference (Toronto: Canadian Tax Foundation, 1990), 45:1-60, question 8, at 45:5.

When we responded to the initial question on this matter in 1980, we envisioned the corporation as a mere conduit, the only "asset" of which would be the personal-use property, and that all expenses would be directly and immediately passed through to the shareholder with the object of avoiding the application of subsection 15(1) of the Act and ignoring, administratively, the existence of the corporation.[11]

Although compliance with the shareholder benefit concession apparently resolves the shareholder benefit problem under Canadian tax law, it raises extremely serious questions about the ability to avoid US estate tax on vacation property held by a single-purpose corporation. This article addresses the US tax effect of compliance with the shareholder benefit concession and other issues that may arise with respect to the use of single-purpose corporations.

RECOGNITION OF THE CORPORATE ENTITY

For US federal income tax purposes, taxpayers have often employed corporate entities for valid non-tax purposes but have desired to ignore the existence of those corporate entities for tax purposes. In the celebrated decision of *Moline Properties v. Comm'r.*,[12] a taxpayer who had used a corporation to hold title to real property argued that the corporation was the shareholder's alter ego and that the shareholder, not the corporation, should be treated as the owner of the property. The Supreme Court framed the question as whether the corporation should be treated as a taxable entity separate from the shareholder. The Supreme Court held that a corporation's separate existence would be recognized if the corporation carried on business or was organized for a purpose that could be treated as the equivalent of business activity. The Supreme Court's holding has been interpreted to mean that a corporation's separate existence will be recognized for tax purposes if either

- there is a non-tax business purpose for the existence of the corporation

or

- the corporation conducts actual business activity.[13]

In the years since *Moline Properties* was decided, many lower courts have focused on the level of activity that must be present in order to give effect

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[11] See Claude Désy, ed., *Access to Canadian Income Tax* (Don Mills, Ont.: CCH Canadian) (looseleaf), paragraph 1208. The comment was made in a technical interpretation dated December 4, 1989. Further comments on single-purpose corporations are found at paragraphs 1043, 1452, and 1507, ibid. (Note: This service has ceased publication.)

[12] 319 US 436 (1943). The principle of *Moline Properties* determines whether the existence of the corporation is recognized for tax purposes. The Supreme Court dealt with similar issues in *Com. v. Bollinger, Jr.*, 88-1 USTC paragraph 9233 (SC 1988), and *National Carbide Corp. v. Comm'r.*, 336 US 422 (1949). In these cases, however, the issue was not whether the separate existence of a corporation would be given effect, but rather whether a corporation whose separate existence was given effect could be treated as the agent of its shareholder.

[13] See *Jackson v. Commissioner of Internal Revenue*, 233 F.2d 289, at 290 (2d Cir. 1956); *Carver v. United States*, 412 F.2d 233, at 236 (Ct. Cl. 1969); and *Gene Dooley*, 48 TCM 1372, at 1376 (1984).

to the separate existence of the corporation and have generally concluded that the corporation's existence cannot be ignored if the corporation conducts even limited business activities.[14] Despite the minimal level of business activity required, the courts have in some cases ignored the existence of a corporation, even though there was some business activity, when there was a strong tax avoidance motive for the use of the corporate vehicle.[15] Subsequent to *Moline Properties*, the courts have also examined the business purpose aspect of that case and have held that any valid business purpose justifies the recognition of the separate existence of the corporation for tax purposes.[16]

Because minimal business activity or any valid business purpose results in recognition of the corporate entity under *Moline Properties*, the corporate entity is only rarely disregarded for US federal tax purposes.[17] Nevertheless, it seems entirely possible that a corporation complying with the shareholder benefit concession would be disregarded and that the shareholder would be treated as the owner of the vacation property for US estate tax purposes. First, there is no *business* purpose for the formation and existence of the single-purpose corporation. Rather, the sole purpose for the existence of the corporation is to avoid US estate tax. Furthermore, a corporation complying with the shareholder benefit concession must hold the vacation home *solely* for the benefit of the shareholder (presumably a non-business purpose). Second, *Moline Properties* appears to require *business* activity, not simply activity, in order to give effect to the corporation's separate existence. Although the single-purpose corporation will undoubtedly conduct some activity, this activity is arguably not *business* activity because, consistent with the shareholder benefit concession, all of the corporation's activity is directed solely to the maintenance of the vacation home for the *personal* benefit of the shareholder. Furthermore, even if the single-purpose corporation's activities were regarded as business-related, these activities are so

[14] *Paymer v. Commissioner of Internal Revenue*, 150 F.2d 334 (2d Cir. 1945) (existence of corporation ignored where it held title to property, was entirely passive, and served no business purpose; another corporation that merely obtained a loan and granted a mortgage could not be ignored); and *William B. Strong*, 66 TC 12 (1976), aff'd. 553 F.2d 94 (2d Cir. 1977) (focus on corporate activity—even if business activity is truly minimal, corporate existence will not be ignored).

[15] See *Aldon Homes, Inc.*, 33 TC 582 (1959) (no business purpose, although there may have been sufficient corporate activity for the court to have concluded that the corporations actually conducted business—strong tax avoidance motives apparently led the court to minimize and ignore the corporations' activities).

[16] See, for example, *Crouch v. United States*, 692 F.2d 97, at 99 (10th Cir. 1982) ("Courts have consistently interpreted *Moline Properties* to preclude ignoring the corporation form when the adoption of the form has served a business purpose"—incorporation to avoid usury laws constitutes a business purpose); *Dooley*, supra footnote 13 (business purpose *or* business activity precludes conduit treatment—noting that the courts have recognized the following as business purposes: to limit liability, to avoid usury statutes, to facilitate the liquidation of a bankruptcy estate, and to engage in farming in a foreign country); and *Johnson Bronze Co.*, 24 TCM 1542, at 1553 (1965) (business purpose to limit liability enough to prevent the disregard of a subsidiary corporation).

[17] See *Dooley*, supra footnote 13, at 1375.

minimal and the US estate tax avoidance aspects of the arrangement are so strong that a court could be led to ignore the minimal level of activitv.

SUBSTANCE-OVER-FORM ANALYSIS

Tax Ownership of Property

Under the substance-over-form doctrine so pervasive in US tax law, the substance, not the form, of the transaction controls its characterization for federal tax purposes.[18] Under one branch of the substance-over-form doctrine, the owner of property for tax purposes is determined by reference to who bears and enjoys the burdens and benefits of ownership—not solely by reference to who holds title to the property.[19] Accordingly, even if the separate existence of the single-purpose corporation were recognized under *Moline Properties*, the shareholder of the corporation could be treated as the owner of the vacation home for tax purposes at the time of his death if during his lifetime he had borne and enjoyed the burdens and benefits of ownership of the property.

The burdens-and-benefits test (or a variant of it) appears to have been applied in *Fillman v. United States*.[20] In that case, foreign corporations held stocks and bonds stored in a US bank. Under the US law in effect at that time, stocks and bonds owned by a non-citizen, non-resident were subject to estate tax if the stocks and bonds were located in the United States. The court characterized the issue as who was the "owner" of the stocks and bonds held in the name of the corporations. All actions of the corporations were taken for the benefit of the decedent, and the decedent took action indicating that he was the real owner of the stocks and bonds. Under these facts, the court held that for purposes of the applicable law, the decedent owned and held the stocks and bonds, and his estate was therefore subject to US estate tax with respect to the stocks and bonds.

A shareholder complying with the shareholder benefit concession is required to bear *all* of the economic burdens of ownership of the property, including insurance costs, property taxes, debt payments, upkeep, and maintenance. In contrast, the corporation bears *none* of the current burdens of ownership of the property. Furthermore, the current benefits of ownership of the property redound entirely to the shareholder, who uses the property rent-free; the corporation derives *no* current benefits since the property cannot be rented. Although the corporation may derive some future benefit from the sale of the property, that benefit may never materialize because the shareholder's heirs may choose to continue to hold the property through the corporation or may liquidate the corporation before the property is sold. In any event, it seems clear that the shareholder would bear all of the current

[18] See *Gregory v. Helvering*, 293 US 465 (1935).

[19] *Grodt & McKay Realty, Inc.*, 77 TC 1221 (1981); *Herbert D. Weiner*, 58 TC 81 (1972), aff'd. 494 F.2d 691 (9th Cir. 1974); *Town & Country Food Co.*, 51 TC 1049 (1969), acq. 1969-2 CB xxv; Rev. rul. 78-411, 1978-2 CB 112; and Rev. rul. 72-408, 1972-2 CB 86.

[20] 355 F.2d 632 (Ct. Cl. 1966).

benefits and burdens of ownership and that the corporation would have only the potential benefit of some future sale. Because the shareholder would have all or nearly all of the benefits and burdens of ownership, it seems likely that the shareholder would be treated as the owner of the property on the date of his death for US estate tax purposes.[21]

Conduit Analysis

Another variant of the substance-over-form doctrine is that the actions or ownership of a corporation may be attributed to its shareholders, even though the corporation's existence is given effect under *Moline Properties*. The essence of the authorities establishing this doctrine is that the corporation is merely a "conduit" for the activities of the shareholder.[22]

In *Aiken Industries, Inc.*,[23] the Internal Revenue Service (IRS) dealt with a situation in which a Honduran subsidiary was used by its corporate parent to avoid interest withholding that would otherwise have occurred if interest payments had been made directly to the foreign parent. The court held that the interest and principal payments received by the Honduran subsidiary should not be treated for treaty exemption purposes as "received by" the Honduran subsidiary where the Honduran subsidiary was obligated under a loan agreement to pay the interest and principal to the foreign corporate parent.[24]

In two Revenue rulings, the IRS extended the *Aiken Industries* analysis to situations in which a corporation organized to avoid withholding received a "spread" in interest rates between the rate it collected and the rate it paid with respect to back-to-back loans.[25] Citing *Aiken Industries*, the rulings note that the conduit corporation did not have complete dominion and control over the interest payments. The rulings also note that the existence

[21] See *John B. Mathers*, 57 TC 666 (1972), acq. 1973-2 CB 2; *United Surgical Steel Co.*, 54 TC 1215 (1970), acq. 1971-2 CB 3; *Town & Country Food Co.*, supra footnote 19; GCM 39584, December 3, 1986; and IRS ltr. rul. 8809028, March 12, 1988, all of which determine the owner of property for US federal tax purposes by examining the burdens and benefits of ownership and by determining which person has the predominant share of those burdens and benefits.

[22] See Philip S. Winterer, "Use of Thinly Capitalized Corporate Intermediaries in Financing Transactions" (Spring 1989), 16 *The Journal of Corporate Taxation* 3-22, at 13-17.

[23] 56 TC 925 (1971).

[24] Ibid., at 934: "Industries obtained exactly what it gave up in a dollar-for-dollar exchange. Thus, it was committed to pay out exactly what it collected, and it made no profit on the acquisition of [the] note in exchange for its own."

[25] Rev. rul. 84-153, 1984-2 CB 383; and Rev. rul. 84-152, 1984-2 CB 381. The IRS has also issued Rev. rul. 87-89, 1987-2 CB 195, relating to three situations in which a third party made a loan to a US corporation after receiving a deposit from an affiliate of the US corporation. This structure was also intended to avoid US withholding tax. The IRS ruled that unless the loan would have been made on substantially the same terms without the deposit, the transaction would be recharacterized as a direct loan from the affiliate to the US corporation because the deposit and the loan were "dependent" transactions used as a device to disguise the substance of the transaction. This ruling arguably goes further than *Aiken Industries* and Revenue rulings 84-153 and 84-152, because the foreign corporation was an independent lender and was not organized solely for purposes of the transaction.

of the corporation was principally based on tax avoidance and that there was not sufficient "business or economic purpose to overcome the conduit nature of the transaction."[26]

Neither *Aiken Industries* nor the rulings cite *Moline Properties*, or any of the cases decided thereunder, in support of the proposition that the existence of the foreign subsidiary should be ignored. Indeed, the Tax Court in *Aiken Industries* specifically acknowledged that it was giving effect to the corporate existence of the foreign subsidiary,[27] but that the foreign subsidiary was a "collection agent" or "conduit" for interest payments from the subsidiary to the foreign corporation.[28] Accordingly, neither *Aiken Industries* nor the rulings should be regarded as inconsistent with *Moline Properties*. These authorities do not treat the foreign corporation as a non-entity; rather, because of the contractual obligations and lack of business purpose of the intermediary corporation, they treat the intermediary corporation as an agent or extension of another taxpayer (that is, the shareholder).

The upshot of these cases and rulings is that a foreign corporation used principally to avoid tax which acts merely as a conduit for its shareholder, and not in any independent capacity, may be treated as the mere extension of its shareholder. A single-purpose corporation is necessarily established for the principal purpose of avoiding US estate tax, and the very nature of the restrictions placed on a single-purpose corporation by the shareholder benefit concession makes it apparent that a corporation complying with the shareholder benefit concession is not acting in any independent capacity. For these reasons, it seems entirely possible that the IRS could challenge the effect of a single-purpose corporation to avoid US estate tax.[29]

IRC SECTIONS 2038(a)(1) AND 2036(a)

IRC section 2038(a)(1) provides that a decedent's gross estate includes the value of the property he has gratuitously transferred by trust or otherwise if the property is subject to the exercise of a power (whether exercisable by the decedent alone or in conjunction with others), at the time of the decedent's death, to change the beneficial enjoyment of the property. Similarly, under IRC section 2104(b), if a non-resident alien makes a transfer of US situs property within the meaning of section 2038, the non-resident alien's US gross estate will include the value of the property transferred. The most common application of this principle occurs where property transferred to

[26] Rev. rul. 84-152, supra footnote 25, at 382.

[27] Supra footnote 23, at 932.

[28] Ibid., at 932-34.

[29] One commentator has argued that *Fillman* is a "nominee" (that is, conduit) case. See Robert C. Lawrence, *International Tax and Estate Planning* (New York: Practising Law Institute, 1983), 190. This reading may be appropriate. Not only did *Fillman* decide the question whether the corporation or the shareholder was the owner of the property held by the corporation, but the decision fairly can be read as holding that the corporation was merely a conduit for the shareholder.

a revocable trust is included in the transferor's gross estate because the grantor has the right to revoke the trust.

Some estate tax examiners have contended (apparently in a non-Canadian context) that the principles of section 2038(a)(1) should apply to a non-resident alien's transfer of US situs property to a foreign corporation. On the basis of the phrase "by trust or otherwise" in section 2038(a)(1), these examiners have apparently argued that a section 2038(a)(1) transfer (which need not be made to a trust) has occurred because the non-resident alien through his stock ownership continues to have the right, following the transfer, to control the enjoyment of the underlying property. Under this analysis, the property could be included in the non-resident alien's US gross estate, not because he owns stock in a foreign corporation, but because he has the power to alter or change the beneficial enjoyment of the property owned by the foreign corporation. There may be some support for this analysis in dicta in *Estate of Oei Tjong Swan v. Commissioner of Int. Rev.*,[30] a case involving a foreign entity that was not a corporation under foreign law but may have been a corporation under US law.

Under IRC section 2036(a), the estate of an individual who gratuitously transferred property by trust or otherwise and retained the possession or enjoyment of the property transferred, or the right to designate the persons who will possess or enjoy the property, must include as part of the decedent's gross estate the property transferred. Section 2104(b) triggers the application of section 2036(a) in the context of a non-resident alien's transfer of US situs property if the transfer would otherwise fall within the ambit of section 2036(a).

In *Estate of William du Pont, Jr.*,[31] a taxpayer transferred residential and recreational real estate to his wholly owned corporation and continued to use the property, paying substantially less than the fair rental value of the property for its use. The taxpayer then transferred all of his stock in the corporation to an irrevocable trust in which he retained no interest. The Tax Court held that the property transferred to the corporation was includible in the taxpayer's gross estate under section 2036(a) because the taxpayer continued to use the property without adequate consideration.[32]

By their terms, sections 2038(a)(1) and 2036(a) do not apply to a "bona fide sale for adequate and full consideration in money or money's worth." Assuming that the stock in the foreign corporation received has a value equal to the property transferred to the foreign corporation, and assuming that the stock can therefore be treated as adequate and full consideration for the property, sections 2038(a)(1) and 2036(a) would not apply. Neither section 2038(a)(1) nor 2036(a) has been directly applied to the receipt of stock for

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30 247 F.2d 144 (2d Cir. 1957).

31 63 TC 746 (1975).

32 The property was not rented at a fair market rental rate.

the transfer of property to a foreign corporation,[33] and the availability of the adequate consideration exception is unclear because of the existence of the *Swan* and *du Pont* cases.[34]

Both sections 2038(a)(1) and 2036(a), read literally, appear to require that the taxpayer have *transferred* an interest in the particular property. If a foreign corporation obtained cash from the shareholder of the foreign corporation in order to purchase the residence, one might argue that neither of these sections could apply because the shareholder would never have owned a direct interest in the property.[35]

PLANNING

Vacation Homes Not Owned by a Corporation

For those taxpayers who have not yet purchased a US vacation home, a number of alternatives may be available to avoid the US estate tax. These techniques have been discussed in detail in the literature.[36] Some of these planning techniques include the use of non-recourse indebtedness,[37] the conversion of the residence into cash *before* death, the joint ownership of the residence by a husband and wife so that each spouse may take advantage of the $60,000 exemption equivalent, and the use of life insurance to fund the estate tax liability.

Another alternative would be to hold the US residence in a Canadian corporation that would *not* satisfy the requirements of the shareholder benefit concession. For example, the vacation property could be held by a corporation holding regular corporate meetings, maintaining its own bank account, paying its own expenses (even if the funds are loaned or contributed by the shareholders), and renting the property at market rates to the shareholder (as well as to third parties). By these actions, the *Moline Properties* problem could be avoided, the burdens and benefits of the ownership of the

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[33] Angelique L. Hamilton and Gordon E. Cooper, "Estate Planning for Canadians with US Assets" (March 1991), 10 *Estates and Trusts Journal* 176-216, at 201.

[34] See Monte A. Jackel, "Taxing US Assets Held by a Foreign Holding Company—The Return of *Swan* and *Fillman*" (June 1990), 19 *Tax Management International Journal* 263-67. The adequate consideration exception to section 2038(a)(1) was not specifically raised in the appellate court's decision in *Swan*, although the decision can be read as inconsistent with the notion that the foreigner's interest received was adequate consideration for the transfer of the property. In *du Pont*, the adequate consideration question with respect to the transfer of the property for stock was not directly raised; however, the Tax Court's conclusion that the payment of adequate rent was required to avoid section 2036(a) in the circumstances at issue implies that the court would have rejected an adequate consideration analysis.

[35] Such a series of transactions might be subject to attack on the ground that sections 2036(a) and 2038(a)(1) should be applied as though the decedent actually transferred an interest in the residence. See *Estate of Stanton A. Levin*, 90 TC 723 (1990).

[36] See, for example, Hamilton and Cooper, supra footnote 33. Persons holding the US residence outright must consider the US tax effects of the transfer of the property to a Canadian corporation: Tony Swiderski and Steve Peters, "Softening the Death Tax Sting" (March 1990), 27 *CA Magazine* 27-33, at 30-31.

[37] Hamilton and Cooper, supra footnote 33, at 187-94.

property could in fact be transferred to the corporation, and the corporation would not simply be acting as a conduit for the sole benefit of the shareholder. Therefore, such a corporation would likely avoid US estate tax.[38] Of course, structuring a transaction in this manner may result in a shareholder benefit. However, on the basis of dicta in the *L. Youngman v. Canada* case,[39] some commentators have suggested that it may be possible to minimize the shareholder benefit problem with appropriate planning.[40]

Existing Single-Purpose Corporations

As noted above, it seems entirely possible (if not likely) that a corporation rigidly adhering to the shareholder benefit concession would not avoid US estate tax on the death of its shareholder. In these circumstances, a shareholder's alternatives for remedying the problem may be quite limited.

One alternative that shareholders may pursue (by default) is to do nothing and run the "audit lottery" risk. Where the tax adviser or a client will serve as executor of the estate, this question becomes important; in the United States, the executor of the estate can be made liable for estate taxes not paid.[41]

Another alternative may be the distribution of the residence from the corporation. However, while the IRS is free to challenge the form of a taxpayer's transactions, a taxpayer is often not free to challenge the form in which he cast a transaction.[42] Accordingly, the IRS could claim that if an appreciated residence were distributed from a Canadian corporation, US income tax should be imposed on the difference between the value and the adjusted cost base of the residence. Furthermore, Revenue Canada might also assert that gain should be recognized and income tax paid (subject to a foreign tax credit). In order to avoid this potential gain on the distribution of the home, rulings from both the IRS and Revenue Canada would have to be obtained. The basis of each ruling would be that because the shareholder adhered to the shareholder benefit concession, the shareholder should be treated as the real owner of the residence so that the transfer from the corporation to the shareholder would not be treated as a taxable event. Whether the IRS and Revenue Canada would treat the transaction in this manner is obviously subject to question.

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[38] This conclusion assumes that sections 2038(a)(1) and 2036(a) do not apply.

[39] [1990] 2 CTC 10 (FCA).

[40] Hamilton and Cooper, supra footnote 33, at 198-200.

[41] Although under current law the IRS cannot enforce US tax liabilities in Canada, one cannot discount the possibility that future tax treaty amendments will grant the IRS the ability to enforce US tax deficiencies in Canada. Furthermore, if there is property in the estate that will be transferred to US beneficiaries, the United States could reach those assets to collect the tax.

[42] *Commissioner v. Nat. Alfalfa Dehydrating*, 417 US 134 (1974); and Robert Thomas Smith, "Substance and Form: A Taxpayer's Right To Assert the Priority of Substance" (Fall 1990), 44 *The Tax Lawyer* 137-79.

As an alternative to the distribution of the residence, some of the planning techniques previously suggested for a residence not held in a single-purpose corporation might be employed. For example, the residence might be encumbered by non-recourse indebtedness, so that if the IRS asserted that the home was owned by the deceased, the estate tax problem would be minimized. Furthermore, the residence might be sold prior to death to avoid the US estate tax.[43]

Finally, a careful review of each client's situation may be in order. For example, the adviser may ascertain upon review of the client's books and records that the client has not adhered to the shareholder benefit concession in all material respects, and that therefore the corporation may in fact have substance for US purposes and may avoid the US estate tax. Of course, the problem with this analysis is that if the shareholder benefit concession has not been rigidly adhered to, Revenue Canada may assert a shareholder benefit.

CONCLUSION

The use of a single-purpose corporation to avoid US estate tax is problematic. Although one should perhaps not criticize the former practice of using a single-purpose corporation (because of the potential estate tax savings), it seems at the very least questionable whether single-purpose corporations complying with the shareholder benefit concession would withstand scrutiny.

Rumour has it that ongoing treaty negotiations may result in a credit mechanism for the Canadian deemed disposition and US estate taxes. Obviously, that would go far in avoiding the problems discussed above. Unfortunately, the existence of a credit mechanism will not alleviate all problems. For example, there may be no deemed disposition tax (because there is no appreciation in the property), yet an estate tax may be imposed. Furthermore, the existence of a credit mechanism will not avoid the problems of holding the residence in a corporation. Practitioners will therefore likely continue to search for ways of avoiding US estate tax and dealing with existing single-purpose corporations.

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[43] However, the corporation's sale of the home and the subsequent distribution of the proceeds of the sale may result in a double tax. See Swiderski and Peters, supra footnote 36, at 30. To alleviate this problem, stock in the corporation could be sold, rather than selling the home and distributing cash.