Cornell International Law Journal

Volume 20
Issue 2 *Summer 1987*

Article 7

Tax and Exchange Rate Aspects of Private Investment in Canadian Vacation Property

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TAX AND EXCHANGE RATE ASPECTS OF PRIVATE INVESTMENT IN CANADIAN VACATION PROPERTY

I. INTRODUCTION

Two United States taxpayers, X and Y, wish to purchase vacation homes on or near the St. Lawrence Seaway; both have $20,000 in U.S. cash to invest. They find two parcels of vacation property for sale in the Alexandria Bay-Thousand Island area. One parcel lies within the U.S. border in Alexandria Bay; the other parcel is located on the Ontario side of the Seaway. Both properties are listed for sale at $100,000 in their respective currencies. Buyer X purchases the property on the U.S. side for $20,000 down and executes an $80,000 mortgage. Buyer Y, purchasing the Canadian property, has several options unavailable to the buyer of the U.S. property. Assuming a 35% rate of exchange,[1] Y may purchase his Canadian property in any of the following ways:

a) by paying $20,000 (U.S.) (worth $27,000 Can.) down and taking a $73,000 (Can.) mortgage;[2]
b) by paying $20,000 (U.S.) down and taking a $54,074.07 (U.S.) mortgage;[3]
c) by reducing his down-payment by the current rate of exchange (35%) and increasing his borrowing leverage accordingly—i.e., by paying $14,814.81 (U.S.) down and financing the balance by either a U.S. or Canadian purchase money mortgage, thereby putting himself in much the same debt position as Buyer X, but saving 35% out-of-pocket expense; or
d) by finding another Canadian property that is priced at $135,000 (Can.), thereby choosing to spend as much as Buyer X but buying "more" property.

In short, Buyer Y may choose either to buy a $100,000 (Can.) vacation home for $65,000 (U.S.), or to buy a $135,000 (Can.) home by incurring the same amount of indebtedness as Buyer X incurs in buying his $100,000 (U.S.) property.[4]

This Note advances the thesis that a favorable rate of exchange and tax deduction for mortgage interest payments provide the U.S. taxpayer who buys Canadian vacation property with at least a double economic benefit not available to the U.S. taxpayer who purchases similar domestic property. This economic benefit consists of an increase in buying power and an inherent hedge against inflation, both of which result from the exchange rate between Canadian and U.S. dollars.[5]

This Note briefly examines the investment possibilities and tax consequences for U.S. purchasers of real property in Canada.[6] Part I

1. The foreign currency exchange market is, of course, in a constant state of flux. "[T]he skittishness of money speculators . . . drove the Canadian dollar down as low as 69.13 American cents on Feb.4. . . . The apparently stabilized Canadian dollar now buys a bit less than 72 American cents." N.Y. Times, Feb. 26, 1986, at D1, col.4. As of this writing, the Canadian dollar is valued at .7164 U.S. dollars, and the U.S. dollar translates to 1.3967 Canadian dollars. N.Y. Times, Feb. 19, 1986, at D16, col. 6. For the sake of simplicity, this Note uses a 35% figure—i.e., $1.00 U.S. is worth $1.35 Canadian. The basic principles involved in regard to the exchange of currencies, however, remain unchanged regardless of the exact rate in effect at any one time.

2. Using a 35% rate of exchange, $20,000 U.S. = $27,000 Can.; $27,000 Can. + $73,000 Can. = $100,000 Can.

3. $20,000 U.S. + $54,074.07 U.S. = $99,999.99 Can.

4. In all of the above financial schemes, both Buyer X and Buyer Y will be able to fully deduct their interest payments under current U.S. tax law. I.R.C. § 163 (CCH 1986).

5. In addition, the recent elimination of consumer interest deductions in the United States, I.R.C. § 163(h) (CCH 1986), and the resulting attractiveness of home equity loans for which interest expense remains fully deductible, create a tax incentive to leverage the transaction and deduct the interest expense incurred. This incentive is even greater for the U.S. buyer of Canadian real property, who can claim a tax deduction unavailable to the native Canadian buyer. *But see infra* note 14, outlining the relationship of the Canadian Registered Home Ownership Savings Plan to the U.S. tax deduction.

6. Investment in Canada is used as the model since Canada (1) is proximate to the continental United States; (2) possesses governmental stability; (3) has well established tax relations with the United States through treaty; and (4) has a current rate of exchange favorable to U.S. investors. Other countries could, of course, be used in such a model.

of this Note provides a general background by describing the current status of the interest deduction in both the United States and Canada,[7] and outlines U.S. tax treatment of domestic vacation homes. Part II surveys some of the regulatory aspects of Canadian real property acquisition by foreign purchasers and the tax consequences of such acquisitions. Part III considers some aspects of foreign property financing, ownership, and disposition, and presents a general examination of exchange rate effects on such financing. Although an effort will be made to briefly define certain terms, relationships, and concepts when appropriate, this Note presupposes that the reader has a basic working knowledge of U.S. federal income tax treatment and policy.

II. BACKGROUND

A. AN OVERVIEW OF THE INTEREST DEDUCTION IN THE U.S. AND CANADIAN TAX SYSTEMS

Prior U.S. tax law permitted full deductions for interest expenses incurred to acquire personal use property,[8] and deductions up to $10,000 ($5,000 on separate returns filed by married taxpayers) for

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These same factors of proximity, stability, tax treaty relation, and rate of exchange apply in any risk-to-profit ratio.

7. The interest deduction now codified in the Internal Revenue Code as section 163(a) has its roots in one of the original Civil War income tax statutes. The legislative purpose behind the deduction, however, remains a matter of speculation. Asimow, *The Interest Deduction*, 24 UCLA L. REV. 749 (1977) [hereinafter Asimow, *Interest*] (citing the Act of Mar. 3, 1865, ch.78, § 117, 13 Stat. 469, 479 (1865)); *see also* Asimow, *Principal and Prepaid Interest*, 16 UCLA L. REV. 36, 62-63 (1968) [hereinafter Asimow, *Principal*]. Commentators articulate several probable purposes for the interest deduction. The first, and most common, is that such a deduction serves as a subsidy for home ownership. Asimow, *Interest*, *supra*, at 749; *see also* Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, in SYMPOSIUM: CANADIAN AND AMERICAN PERSPECTIVES ON THE DEDUCTION FOR INTEREST PAYMENTS, 30 WAYNE L. REV. 991 (1984) [hereinafter SYMPOSIUM]. "In an inflationary setting all deductions of interest are subsidized, regardless of the use to which they are put." *Id.* at 1011. Such a rationale seems particularly reasonable given longstanding public policy support for increased home ownership. This home subsidy hypothesis is strengthened by the Tax Reform Act of 1986, which eliminates the deductibility of consumer interest expense other than that used to purchase primary and secondary homes. I.R.C. § 163(h) (CCH 1986).

An alternative explanation for the retention of the deductibility of only mortgage interest is that such an allowance standardizes the type of collateral taken to secure personal loans. Because only mortgage interest on first and second homes is deductible, consumers will be more likely to secure their personal loans through second and third mortgages with their homes as collateral. Although such an occurrence will result in standardizing the type of collateral used, the ultimate effect may be to put personal homes at risk if borrowers overextend themselves. Such a result would conflict with the home subsidy theory of interest deductibility.

8. I.R.C. § 163(a) (CCH 1986). Internal Revenue Code section 163 now contains a new section 163(h), which disallows the deduction for personal interest that is not secured by a mortgage on the taxpayer's primary or secondary "Qualified Residence." Internal Revenue Code section 163(h)(5) defines "Qualified Residence" as the taxpayer's principal residence and one other residence the taxpayer may select. *Id.* § 163(h)(5).

interest expenses incurred on indebtedness to acquire investment property.[9] In other words, so-called consumer interest was deductible in full, and "investment interest" was deductible to certain limits.[10] The new Internal Revenue Code of 1986 eliminates the deductibility of consumer interest, with the exception of interest expenses incurred to purchase first and second homes.[11] Investment interest is generally deductible only up to the amount of net investment income claimed by the taxpayer. The investment interest expense deduction, therefore, is "capped" by the amount of earned net investment income.[12]

In contrast, Canadian tax policy allows interest expense deductions only to the extent that such interest is incurred to acquire income-producing assets and properties.[13] Thus, no allowance exists for personal use consumer interest, including interest incurred to purchase a residence.[14] The Canadian system permits deductions only

9. *Id.* § 163(d). Amended extensively in 1986, section 163(d) now provides for a "phase-in" of a disallowance (i.e., phasing-out the deduction) for interest. *Id.* Since the amendments to section 163 continue to allow deductions for mortgage interest on two homes for each taxpayer, the effect of the extensive revisions to section 163 are beyond the scope of this Note.

10. *Id.* The Treasury Department's original tax reform proposal recommended that fully deductible "consumer interest," which included the interest incurred to purchase a vacation home (but expressly excluded that interest incurred for a taxpayer's primary residence), be combined with investment and nonbusiness interest and limited to a $5,000 deduction, rather than the then current $10,000 for investment interest deductions. TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, 2 Fed. Taxes (P-H) ¶ 59,476. That proposal would have reduced by more than half the amount of deduction available for both consumer and investment interest payments. The House version of the bill, however, deleted this aspect of the reform proposal. The version enacted into law expressly retained the interest deduction for both primary and second homes. I.R.C. § 163(a), (h) (CCH 1986).

Tax reform treatment of the interest deduction, however, has long been a favorite goal of tax reformers and legal scholars. *See generally, e.g.*, SYMPOSIUM, *supra* note 7, at 941-1021. The possible effects of such reform on the vacation, or second, home real estate market in the United States—which, according to the N.Y. Times (Sept. 2, 1985, at 9, col.1), numbers some 2.7 million homes worth approximately $10 billion—would be significant and far-reaching.

11. I.R.C. § 163(h) (CCH 1986).

12. *Id.* § 163(d)(1).

13. Income Tax Act, ch. 63 § 20(1)(c), 1970-1972 Can. Stat. 1370, *amended by* ch. 140, § 12, 1980-1983 Can. Stat. 3821.

14. *Id.* The net result of the interaction between codes is that an alien U.S. taxpayer may finance the purchase of Canadian real property and deduct from his U.S. tax return the interest expense incurred in such a transaction, while a native Canadian taxpayer receives no similar deduction if the real property is acquired for personal use. The disparity between the systems, however, is alleviated somewhat in the Canadian system by homeowner access to the Registered Home Ownership Savings Plan ("RHOSP") and the Canadian Home Ownership Stimulation Plan. The RHOSP was added to the Canadian law relating to income tax by ch. 26, § 146.2, 1974-1976 Can. Stat. 629, and subsequently amended by ch. 4, § 57, 1976-1977 Can. Stat. 113; ch. 1, § 73, 1977-78 Can. Stat. 155; ch. 5, § 48, 1979 Can. Stat. 119; ch. 140, § 99, 1980-1983 Can. Stat. 4005; ch. 1, § 81, 1984 Can. Stat. 161; ch. 45, § 54, 1984 Can. Stat. 1690.

Very simply, a RHOSP serves as a one-time, nontaxable investment fund for the potential Canadian home-buyer who may deposit up to $10,000 for later investment in a newly for interest incurred "for the purpose of earning income from a business or property."[15]

Classification of property, therefore, has even more important tax consequences in Canada than in the United States. In the United States, classifying a first or second home mortgage as either a personal use or a business expense merely results in a different kind of allowable deduction.[16] In Canada, however, the classification determines whether some deduction is allowed, or none at all. More specifically, a Canadian taxpayer may only take an interest expense deduction in the following circumstances: (1) on money borrowed for acquiring income-producing property or a business; (2) on certain amounts paid under an appropriation act for the subsidization of manufacturing, prospecting, drilling, and exploring for minerals; and (3) on investments in certain annuities.[17]

B. UNITED STATES TAX TREATMENT OF RENTAL INCOME FROM DOMESTIC VACATION HOMES

United States tax treatment of domestic vacation homes used to generate income is largely governed by section 280A of the Internal

built home; alternatively, if the home meets certain qualifications, the home-buyer may be entitled to a $3,000 grant under the Canadian Home Ownership Stimulation Plan. Strother, *Income Tax Implications of Personal-Use Real Estate*, in INCOME TAX ASPECTS OF REAL ESTATE TRANSACTIONS 76-79 (1983) [hereinafter INCOME TAX ASPECTS] (proceedings of the 1983 Corporate Management Conference). Unfortunately for Canadian home buyers, these deductions and grants are alternatives and available only once to the Canadian home-buyer, and only to buy a newly constructed home. *Id.*

15. Income Tax Act, ch. 63, § 20(1)(c)(i-ii), 1970-1972 Can. Stat. 1370, *amended by* ch. 140, § 12, 1980-1983 Can. Stat. 3821; *see* R.J. Smith, *Sales of Real Estate: Tax Planning for the Buyer*, in INCOME TAX ASPECTS, *supra* note 14, at 167. In respect to rental income gained from ownership of Canadian real property, such property is deemed to be "business property":

> [1] where a single-purpose nonresident company is used to own and operate . . . an apartment, office building, or shopping centre complex . . . ; or
> [2] where a service-related property (hotel or apartment complex with hotel-like services) is owned *and* operated by or for the account of the investor. . . .

Boidman, *Nonresident Investment in Canadian Real Estate*, in INCOME TAX ASPECTS, *supra*, at 376. Thus, in the present context, and at least with respect to individual, direct ownership, the renting of Canadian vacation property does not necessarily result in the classification of the vacation home as "business property" under Canadian tax law because:

> [C]ase law is to the effect that the ownership and leasing of space by an individual are not considered to be the carrying on of a business unless the services provided amount . . . to those of a service business, such as that of a hotel keeper. This will generally be so even if the rental property is substantial in size and value, and requires a large staff to provide standard janitorial services and carry out administrative and clerical functions.

Id. at 375. The relevance of the distinction and resulting classification of the property interest in both systems will be apparent to the reader in Parts I and II of this Note, where vacation home tax treatment, including rental considerations, is discussed.

16. *See supra* notes 11-12 and accompanying text.

17. Income Tax Act, ch. 63, § 20(1)(c)(iii-iv), 1970-1972 Can. Stat. 1370, *amended by* ch. 140, § 12, 1980-1983 Can. Stat. 3821.

Revenue Code.[18] Treatment depends to a great extent on the amount of time the home is used as rental property in relation to the amount of time the home is used for personal purposes.[19] At one end of the spectrum, the vacation home may be used solely for personal enjoyment. In such a case, the taxpayer may fully deduct mortgage interest payments, along with property taxes and accidental damages (i.e., casualty losses).[20] At the other end of the spectrum, the residence may be used solely for rental purposes, in which case gross rents must be reported as income;[21] operating costs and property depreciation, however, become additional deductions along with interest payments, property taxes, and casualty losses.[22] Falling in the middle of this spectrum is mixed-use tax treatment, which allows a percentage of the additional deductions (and demands the reporting of gross rental income) according to the ratio of rental days to personal use days.[23]

Section 280A's "fourteen-day rule" is important in this context. If vacation property is rented for fourteen days or less, the United States Internal Revenue Code directs the Internal Revenue Service ("I.R.S.") to assume a wash between operating expenses and rental income, and does not require the taxpayer to report rents received.[24] Within this fourteen-day "limited rental use" grace period, the taxpayer cannot both forego the declaration of rental income and claim deductions for operating expenses and depreciation. The taxpayer, however, may still deduct any mortgage interest payments.

A similar fourteen-day grace period is available for "limited personal use" near the all-rental end of the spectrum. Rather than claim that the property is primarily for personal use with only minimal rental use, the taxpayer in this context claims that the property is used primarily to produce income in the form of rents. Here, the personal

18. I.R.C. § 280A (CCH 1986). Section 183 may also apply if the property is used solely as rental property but does not generate profit.

19. For more extensive discussion of the new tax treatment of domestic vacation homes, see Kerr, *The Rental of Personal Residences: Implications of Section 280A*, 7 J. REAL EST. TAX'N 139 (1980); Lathen, *Bolton: IRS "Bizarre" on Section 280A(e)*, 60 TAXES 237 (1982). A more mathematical approach, complete with flow-charts, and from which much of this section is derived, is Enis, *Vacation Homes: Tax Treatment and Tax Planning Based on a Mathematical Formulation*, 12 J. REAL EST. TAX'N 52 (1984).

20. I.R.C. § 280A(b) (CCH 1986); *see also id.* § 163 (interest); *id.* § 164 (taxes); *id.* §§ 280A(a), 165(a) and (c) (casualty loss).

21. *Id.* § 61.

22. *Id.* §§ 162, 280A. Note in particular I.R.C. § 280A(f)(3), which outlines the section's coordination with § 183. For a brief discussion of the "hobby loss" rules of section 183 and the establishment of a "profit motive," which is pivotal to the section, see Enis, *supra* note 19, at 56-57.

23. I.R.C. § 280A(e) (CCH 1986). The "Service formula" is the formula that is set out in section 280A(e) to allocate expenses between personal and profit motives in mixed use property. *Id.* For an important 9th Circuit variation of the Service formula, see Bolton v. Comm'r, 694 F.2d 556 (9th Cir. 1982), *aff'g* 77 T.C. 104 (1981).

24. I.R.C. § 280A(g) (CCH 1986).

use aspect of the property is so minimal as not to alter that income-producing characteristic. To fall within this classification, however, the taxpayer needs to establish a profit motive for ownership of the property justifying commercial-use tax treatment.[25]

Disagreements concerning section 280A center upon the distinction between personal use days and rental days. The residence is used for personal or recreational purposes if it is used: 1) by an owner or indirect owner of the property (which includes a partner, beneficiary, or shareholder when the property is owned by a partnership, trust, or S corporation);[26] 2) by a person who enjoys a family relationship with such an owner of the property;[27] 3) by a person who has entered into a reciprocal agreement concerning other vacation property with an owner;[28] or 4) by any person paying less than a fair market rental as determined by the standard fair market value of arm's length transactions of similar property in the area.[29] If the owner allows use by an equitable owner or family relation, the owner may still count this time as rental, rather than personal use days; the owner, however, must charge that person a fair rental price for that use.[30]

For tax planning purposes, then, a taxpayer with a vacation home enjoys a tax benefit if he is able to rent that property for a fourteen-day period each year. Because the I.R.S. presumes a wash when the property is rented for less than fifteen days per year, the receipt of rents for such a period is tax-free income.[31] The tax benefit increases if the vacation home is located in a place enjoying a seasonal premium, or rental demand, not in conflict with the taxpayer's own personal preferences. Further, this fourteen-day rental benefit rule applies whether the vacation property in question is domestic or foreign.

Using our beginning hypothetical as an example, the net result of section 280A's presumption of a wash between rental expenses and up to two weeks rental receipts is that taxpayer X may rent his Alexandria Bay cottage in the United States for a total of two weeks in a given year without reporting any income received for such rental. In effect, taxpayer X may regard these rental receipts as tax-free income. To maximize this tax benefit, X should rent the property during the two weeks each year when demand by the renting public is highest;

25. *Id.* § 280A(d). See the hobby loss rules of § 183, *supra* note 22, regarding establishment of profit motivation and realization; *see also supra* note 15 for a discussion of Canadian tax characterization of rental and business use property.

26. I.R.C. § 280A(d)(2)(A) (CCH 1986); *see also* Enis, *supra* note 19, at 57.

27. I.R.C. § 280A(d)(2)(A) (CCH 1986); *see also* Enis, *supra* note 19, at 57.

28. I.R.C. § 280A(d)(2)(B) (CCH 1986); *see also* Enis, *supra* note 19, at 57.

29. I.R.C. § 280A(d)(2)(C) (CCH 1986); *see also* Enis, *supra* note 19, at 57.

30. I.R.C. § 280A(d)(2)(C) (CCH 1986); *see also* Enis, *supra* note 19, at 58.

31. Enis, *supra* note 19, at 62.

ideally, these same two weeks provide X with the least amount of personal enjoyment.

For example, X, a non-sailor who most enjoys his Alexandria Bay property during the fall and winter months, may rent his cottage during the week of July 4th, and during the week of the big annual regatta in August. This choice ensures that X will have a sufficiently large market of potential renters for his property and will be able to command the maximum (nontaxable) rental rates. This same matching of rental value with personal preference may occur when the taxpayer is a non-skier who owns a vacation home in the mountains near a ski basin, or is a non-hunter with a cabin in a region known for its good hunting. Such matching enables the taxpayer to receive the maximum two week rental value at minimal personal sacrifice.

Canadian tax treatment of the interest deduction differs from that of the I.R.S. in several important respects.[32] In general, the U.S. taxpayer who buys Canadian real property must pay Canadian taxes on any income derived from that property ownership.[33] If the property, however, is an income-producing property run for profit, Canadian law allows the U.S. taxpayer deductions for related expenses (including interest) and capital cost allowances (i.e., depreciation);[34] if, on the other hand, the property is a personal use property, such as a vacation home with little or no third party rental, the U.S. taxpayer, unlike his Canadian counterpart, may fully deduct his interest payments on his

32. Under Canadian tax law, only interest incurred on indebtedness entered into for the purpose of earning income is deductible; no deduction is allowed for consumer interest incurred to purchase first or second homes. Income Tax Act ch. 63, § 20(1)(c), 1970-1972 Can. Stat. 1370, *amended by* ch. 140, § 12, 1980-1983 Can. Stat. 3821. The Canadian Charter Commission chose not to allow deductions for the payment of any mortgage interest, on either a primary residence or a second home, arguing that such treatment discriminated in favor of the homeowner over the renter. 3 REPORT OF THE ROYAL COMMISSION ON TAXATION 49 (1966); *see also* Bale, *A Call for Fundamental Tax Reform from the U.S. Treasury: Some Implications for Canada*, 33 CAN. TAX J. 269, 286-88 (1985), in which the author suggests that such a position may be overbroad because it fails to discriminate between those homeowners who must borrow to purchase their home and those who own their home without borrowing. Bale contends that a better method equalizing renters, mortgagors, and debt-free homeowners would be to allow the interest deduction for mortgagers but add the rental saved to their income, essentially a system of "imputed" rental income.

33. Income Tax Act, ch. 63, § 212(1)(d), 1970-72 Can. Stat. 1819; *see also* Boidman, *supra* note 15, at 380:

> A direct foreign investor is entitled to pay Canadian tax on net income derived from rental real estate whether the property is considered to be business property or nonbusiness property. In the latter case, however, elective procedures are required, in the absence of which a 25 per cent Canadian tax is applicable to gross revenue receipts without relief or deduction for any costs or expenditures, pursuant to paragraph 212(1)(d) of the Act.

Id.

34. The Canadian version of depreciation is termed "Capital Cost Allowances" and is provided for in § 20(1)(a) of the Income Tax Act. Income Tax Act, ch. 63, § 20(1)(a), 1970-1972 Can. Stat. 1370.

domestic tax return.[35]

This overview of the interplay between the U.S. and Canadian tax systems is also an oversimplification. Depending upon the nature of the property and its location, various controls and transactional taxes may affect the investment. The following section examines these controls and limitations.

III. REGULATION OF CANADIAN REAL PROPERTY ACQUISITION: LIMITATIONS AND CONTROLS

The United States and Canada enjoy a long tradition of interborder transactions and investments.[36] Both countries have established firm treaty relations to encourage such activities.[37] Restrictions, however, exist on both sides of the border concerning foreign investment in domestic real property. Foreign acquisitions, when allowed, still encounter different tax consequences.

A. Foreign Investment Review Act

One limitation is the Canadian Foreign Investment Review Act ("the Act").[38] The Act applies primarily to income-producing property on a grand commercial scale rather than vacation home property rented only on an occasional basis. The prominence of the Act, however, and the consequences of review—sometimes fatal to a transaction—suggests at least a summary look at the Act.

In general, the Foreign Investment Review Agency ("the Agency") must approve any foreign acquisition of property deemed a "carrying on" of business, or a continuation of an existing business in Canada.[39] The Act defines a "business" as "any undertaking or enterprise carried on in anticipation of profit."[40] Furthermore, the Act draws a distinction between acquisitions made to carry on a business and acquisitions for investment.[41] Thus, the Agency will not scrutinize vacation home purchases in most instances, even if the taxpayer primarily views the home as a "good investment."[42]

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35. I.R.C. § 163 (CCH 1986).

36. *See, e.g.*, Brown, *Current Tax Issues in Canada-United States Relations: The Love-Hate Relationship Continues*, 8 CAN.-U.S. L.J. 75 (1984).

37. A detailed analysis of international tax treaties is beyond the scope of this Note. For a recent treatment of the subject in regard to the interaction and relation between the United States, Canada, and the United Kingdom, see Osgood, *Interpreting Tax Treaties in Canada, the United States, and the United Kingdom*, 17 CORNELL INT'L L.J. 255 (1984).

38. Foreign Investment Review Act, ch. 46, 1973-1974 Can. Stat. 619.

39. Arnold, *U.S. Investment in Canadian Real Estate*, 4 CAN.-U.S. L.J. 112 (1981).

40. Foreign Investment Review Act, ch. 46, § 3(1), 1973-1974 Can. Stat. 621.

41. Arnold, *supra* note 39, at 112.

42. A non-resident investor, on the other hand, who maintains an office in Canada, regularly enters into contracts in Canada, and disposes of taxable Canadian property other

The Agency makes three determinations in assessing the Act's applicability. The first inquiry relates to the type of real property being acquired. If the rental value of the property exceeds $10 million, for instance, the acquisition will generally qualify as the carrying on of a business in Canada. Such a transaction requires Agency approval. Similarly, if the acquired property has a natural connection to assets associated with an existing or proposed Canadian business, the acquisition may require approval by the Agency. If, however, the connection is with a "circulating asset"—i.e., a short-term asset frequently acquired and disposed of—the acquisition may not necessarily be considered a carrying on of business.[43]

Second, the Agency inquires into the nature and type of seller in the proposed transaction—that is, whether the seller is, or has previously been, engaged in similar transactions in anticipation of profit.[44] Third, the Agency inquires into the nature and type of buyer in the proposed transaction.[45] The Agency seeks to determine whether the buyer and seller are commercial dealers in real property; if so, the proposed transaction meets the "carrying-on or continuation of business" standard and thus requires Agency approval.

For the most part, then, the Act will not affect a private investor.[46] The Act does not affect even those investors who intend limited rental of their property. Our hypothetical Buyer Y, for example, looking to purchase Canadian Thousand Island property for personal use, will not come within the guidelines of the Act and will not be subject to Agency review. The result may be different, however, should Y contemplate extensive rental of the property *and* provide innkeeper-like services to his tenants.[47]

B. Statutory and Provincial Limitations

The potential foreign purchaser of Canadian real property should be aware of various controls and limitations imposed by the individual Canadian provinces and should engage in appropriate research prior to purchasing Canadian vacation property. These controls usually take the form of a transfer tax or a restriction on the type of land that may be acquired by nonresident purchasers.

than in isolated transactions, whether directly or through agents, may be deemed to be carrying on a business in Canada. 621 Can. Master Tax Guide (CCH) 525, 530 (1984).

43. Arnold, *supra* note 39, at 113.

44. *Id.*

45. *Id.*

46. Note, however, that even a commercial dealer in real estate who seeks to buy vacation property for his own personal use may not automatically be subject to FIRA review. *See, e.g., id.*; *see also* Boidman, *supra* note 15, at 376. In such a case the buyer may be required to establish a nonprofit motive for the transaction.

47. Boidman, *supra* note 15, at 375 n.19.

For example, certain agricultural lands in Ontario are subject to a 20% transfer tax under that province's Land Transfer Tax Act.[48] Certain lands in Quebec are also subject to transfer taxation as well as land restrictions under the Act to Preserve Agricultural Land.[49] In Alberta, the Agricultural and Recreational Land Ownership Act imposes a 20-acre limit on the acquisition of certain lands by aliens.[50] The Manitoba Agricultural Lands Protection Act extends a similar 20-acre limitation to agricultural lands in Manitoba.[51] The Saskatchewan Farm Ownership Act limits acquisition of land in that province to land valued up to $15,000 (Can.) (excluding the value of any buildings), and to no more than 160 acres.[52] Under the Prince Edward Island Real Property Act, that province limits foreign acquisition of land to 10 acres or 330 linear feet of shore-front.[53]

Returning to the hypothetical, provincial restrictions will affect Y's acquisition of Thousand Island property. Because the Thousand Island property is located within the province of Ontario, the Ontario Land Transfer Tax Act requires the payment of a 20% transfer tax. This transfer tax, however, does not represent as great an economic liability to Buyer Y as it may first appear. Because Ontario's transfer tax will qualify as a bona fide foreign tax liability to Y, Y will be entitled on its U.S. tax return to a tax credit in the amount of foreign taxes paid.[54] Even ignoring the effect of this tax credit, the 20% transfer tax would not completely offset the 35% gain represented by the exchange rate; thus, Y still enjoys a 15% gain, at least, on his investment.

IV. ASPECTS OF OWNERSHIP AND FINANCING OF CANADIAN VACATION PROPERTY, AND THE INTERACTION OF AN INFLATIONARY ECONOMY WITH THE RATE OF EXCHANGE

This section gives some consideration to forms of financing Canadian vacation property, i.e., whether the U.S. taxpayer should employ foreign or domestic financing to leverage his acquisition. This section

48. 4 ONT. REV. STAT. ch. 231, §§ 2a-2c (1986); *see also* Arnold, *supra* note 39, at 114.

49. QUE. REV. STAT. ch. P-41.1 (1985). For a discussion of the Quebec Land Transfer Duties Act of 1976 (repealed), see Arnold, *supra* note 39, at 114.

50. 1 ALTA. REV. STAT. ch. A-9, § 3 (1980); *see also* Arnold, *supra* note 39, at 115.

51. 1977 MAN. REV. STAT. ch. 44, *repealed by* ch. 22, § 20, 1982-1984 MAN. REV. STAT. 263; *see also* Arnold, *supra* note 39, at 115.

52. 8 SASK. STAT. ch. S-17, § 8.1 (1986); *see also* Arnold, *supra* note 39, at 115.

53. 2 P.E.I. REV. STAT. ch. R-5 (1975); *see* Morgan v. Atty. Gen. for P.E.I., 1976 S.C.R. 349; *see also* Arnold, *supra* note 39, at 115.

54. I.R.C. § 164(a)(1) (CCH 1986). "Up to now, the United States has bent over backward in insulating Americans from the impact of foreign taxes by being generous in the allowance of a foreign tax credit." Oldman, *Comments on "The Source of Interest Payments Made by Nonresidents,"* in SYMPOSIUM, *supra* note 7, at 1046.

also considers Canadian tax consequences of rental of the vacation property, and the Canadian tax effects of disposition of the property. Before turning to these considerations, however, this Note provides a theoretical overview of the relationship of currency exchange to inflation.

A. An Inflation-Exchange Rate Model

Currency exchange rates have an important effect on transborder real property transactions. In a sense, a favorable exchange rate acts as a "reduction" of the total sales price of real property in much the same way as does the deductibility of interest expense. Under this view, a favorable rate of exchange may act "in lieu of" the interest deduction.[55] The investor, of course, realizes an even greater benefit if a favorable rate of exchange is combined with the deduction for incurred interest expense.

From another view, if interest is by definition the rental payment for the use of borrowed money,[56] for which the rentor should be compensated, a favorable rate of exchange serves as a kind of compensation for the use of another country's devalued currency or assets, such as real property. Accordingly, the greater the difference in exchange rates, and the greater the devaluation of the currency or assets of another country an investor must suffer, the more of a discount that investor should enjoy by way of compensation. This discount represents the appreciated value of the borrower's currency—the currency from which the interest and principal of the loan will be repaid—against the depreciated or inflated lender's currency or assets in which he has invested.

A favorable exchange rate resulting from an inflated, or weaker, lending currency may be viewed as a "secondary appreciation" of the borrower's investment. Thus, the value of Canadian vacation property to a foreign investor may not only increase by the, in most cases, expected and ordinary appreciation of the value of the land itself, but may also appreciate in relation to the changing economic strength of Canadian currency relative to the currency of the purchaser's country.

55. This concept of exchange-rate-as-replacement for interest deduction is particularly important in a tax regime that threatens in the name of reform to remove the deduction. *See supra* notes 8 & 10. The concept is also important in a system, such as Canada's, that does not recognize any personal use interest expense deductions. *See supra* notes 13-15 and accompanying text.

56. McIntyre, *Comments on "Indexing for Inflation and the Interest Deduction,"* in SYMPOSIUM, *supra* note 7, at 973. "We can go a long way toward understanding how interest payments should be treated in a tax system grounded on traditional fairness standards by thinking of interest as a type of rental payment." *Id.*

This basic principle may be best illustrated by returning to our original hypothetical and placing taxpayer Y's Canadian vacation property investment in the middle sector on the following chart:

	Canadian land values		
	$125,000 (Can.)	$100,000 (Can.)	$75,000 (Can.)
$1.50 (Can.)	I.	II.	III.
$1.35 (Can.)	IV.	V. {"Y"}	VI.
$1.00 (Can.)	VII.	VIII.	IX.

$1.00 U.S. currency value.

Assuming that Buyer Y paid a fair price of $100,000 (Can.) for his vacation property in an exchange market where $1.00 (U.S.) is worth $1.35 (Can.)—a 35% rate of exchange—then Y's investment may be represented by sector V in the above diagram. In terms of simple conversion, Y's investment currently represents an economic gain, i.e., increased buying power of 35 per cent. As Y's investment moves to the left of the chart, it represents an appreciation of land values. Movement to the right represents a corresponding decrease in land values. The secondary appreciation factor, which is the rate of exchange, is expressed by vertical movements. Thus, a weakening of the Canadian dollar relative to the U.S. dollar is displayed by an upward movement on the chart; a strengthening of the Canadian dollar is shown by downward movement and results in a corresponding move toward equalization in value between the two currencies.

In post-investment terms, the ideal scenario for Buyer Y would be a trend toward sector VII, i.e., an increase in land value coupled with a strengthening of the Canadian dollar. Such a change represents an increase in the "real" value of Y's investment, since it would then take more U.S. dollars to buy the same property. Conversely, the worst move for Y's investment would be toward sector III: both a decrease in land values and a further weakening of the Canadian dollar.

Another way of viewing this secondary "exchange rate appreciation" factor may be to remember that after Y has made his initial investment, the monetary value of the land is then expressed in Canadian dollars, and his investment is tied directly to the Canadian currency. Its "translation" into other currencies affects the land value from the buyer's point of view. As the Canadian dollar strengthens against the U.S. dollar, so too does the monetary value of the land in regard to U.S. currency. This relationship—or "translation"— may be better shown by placing the following purchase money amounts in their respective sectors on the chart:

	Canadian land value		
	$125,000 (Can.)	$100,000 (Can.)	$75,000 (Can.)
$1.50 (Can.)	I 83,333(U.S.)	II 66,667(U.S.)	III 50,000(U.S.)
$1.35 (Can.)	IV 92,593(U.S.)	V 74,074(U.S.)	VI 55,556(U.S.)
$1.00 (Can.)	VII 125,000(U.S)	VIII 100,000(U.S.)	IX 75,000(U.S.)

The figures within the various sectors in the above chart represent the monetary value of the corresponding land parcels in terms of U.S. currency. That is, the figures represent how many U.S. dollars it would take to purchase a particular piece of real property. In our hypothetical, for example, Buyer Y has purchased Canadian land valued at $100,000 (Can.) in a $1.35 rate of exchange ($1.00 (U.S.) = $1.35 (Can.)) for a sum of $74,074 in U.S. currency. Sector V represents such a position. If after several years Y's property enjoyed a 25% appreciation, it would be valued at $125,000 (Can.), but the amount of U.S. dollars paid to purchase that $125,000 (Can.) piece of Canadian property would vary according to the currency exchange rate in effect at the time. If a future buyer should purchase Y's property in a 50% exchange market (sector I), it would cost him $83,333 U.S. dollars; in a 35% market (sector IV), it would cost $92,593 U.S.; and in a 0% market (sector VII), where the Canadian dollar and the U.S. dollar enjoy equal purchasing power, the land would cost $125,000 in both U.S. and Canadian currency.

Y's investment in Canadian real property, therefore, faces two separate, though somewhat interdependent, possible kinds of appreciation: the appreciation of the land or asset, and the appreciation of the currency. Conversely, Y's investment faces two separate forms of risk: land depreciation and a further weakening of the Canadian dollar.

B. Financing and Ownership Considerations

Before examining considerations of real property financing, two assumptions should be outlined. First, in the interests of clarity, and because a comprehensive survey of real property ownership models is beyond the scope of this Note, nonresident individual ownership of the vacation property is assumed.[57] An assumption of personal direct ownership—rather than ownership through a resident or nonresident corporation, partnership, or trust—also more accurately reflects actual practice in the vacation home context.

Second, this Note assumes that the reader is aware of the general taxing principle, followed in both the Canadian and U.S. systems, that foreign currency money amounts are treated as commodities or "property" and not as domestic cash. Cash in the taxing nation's currency has the same face value and tax basis. A foreign currency, however, may and often does have a tax basis (i.e., cost) that differs from its face amount. In other words, amounts paid or received in foreign currencies must be "translated" into currency of the tax system to which they are reported.[58] If such translated amounts represent financial gain or loss to the taxpayer, such gain or loss is subject to appropriate tax treatment upon realization of a taxable event.[59]

In our hypothetical, several taxable events may require such currency translations. For example, Buyer Y must report the amount, if any, received for rent of his vacation home as income for Canadian tax purposes in terms of Canadian dollars, even if paid to him in the form of U.S. dollars. Conversely, even though he may have financed his vacation home through a Canadian lender who charges him interest in Canadian dollars, Buyer Y must translate those interest amounts into U.S. dollars to deduct them from his U.S. taxes. In essence, these

57. For a more complete analysis of ownership structures of real property in the form of partnerships, trusts, and corporations, see generally Berger, *Real Estate Syndication: Property, Promotion, and the Need for Protection*, 69 YALE L.J. 725 (1960); Page, *Massachusetts Real Estate Syndication: Tax and Other Pitfalls*, 43 B.U.L. REV. 491 (1963); *see also* Boidman, *supra* note 15, at 377-79. Boidman suggests that the nonresident who makes a direct investment (not through any corporate or partnership form or by trust) in Canadian real property, and contemplates commercial or business use of the property, must face three primary tax concerns:

> [1] . . . the deductibility of financing charges;
> [2] the imposition of Canadian withholding tax where a lender is a nonresident; and
> [3] . . . implications, if any, of the dealer . . . not dealing at arm's length with the borrower.

Id. at 377. Such concerns, of course, are eliminated when the taxpayer contemplates primarily personal use of his vacation home and, as suggested in this Note, employs Canadian financing in his acquisition.

58. *See generally* Ravenscroft, *Currency Revaluation and Devaluation—Tax Effects*, 280 Tax Mgmt. (BNA) 1 (Feb. 6, 1984).

59. [G]ain or loss arising from all foreign transactions must be translated from foreign currency into its dollar equivalent by means of an exchange rate. The ultimate taxable income in U.S. dollars may represent one or both of two kinds of income. One kind is the U.S. dollar equivalent at the exchange rate of profit or loss computed in foreign money and then translated into dollars. This kind does not reflect gain or loss from exchange rate changes. The other kind is *gain or loss* from exchange rate changes which results from a comparison of the dollar value of an asset or liability when acquired with the dollar value when disposed of.

Id. at A-1 (emphasis in original).

translations may have the effect of "grossing-up" Y's income (by translating U.S. currency into a greater equivalent Canadian amount), while reducing his deductible interest expense (by translating Canadian interest expense "down" to U.S. amounts). These translations level off some of the inherent discrepancies in the exchange rate, resulting in a closer relationship between face values and actual values of the different currencies.

1. Financing Considerations

When a U.S. taxpayer finances his real property purchase in Canada by borrowing from a U.S. lender, he gambles that the Canadian dollar will appreciate against the U.S. dollar, making the value of his property approximate to the amount of his indebtedness. When a U.S. taxpayer leverages his purchase of Canadian property through borrowing from a Canadian lender, however, he acquires a hedge against the appreciation of that foreign currency. He also enjoys an economic gain through repayment in U.S. funds if the Canadian dollar should depreciate.

For example, if the foreign currency depreciates in value, the borrower, who is paying off a debt in a weakening currency with funds from a strengthening currency, enjoys an economic gain on the loan from the increase of his purchasing, or "pay-back," power. The asset tied to the foreign currency will also most likely depreciate in value in such a situation, but probably not to the extent the currency will depreciate.[60] This tendency is especially true in the context of a traditionally stable asset such as land. Conversely, the domestically financed buyer in such a situation suffers a foreign exchange loss (nondeductible in a vacation home, or nonbusiness, context), since his debt is denominated in the stronger currency. In other words, he must spend more U.S. dollars to repay his debt than he would spend to repay the same amount of indebtedness held in the weaker currency.

If, however, the foreign currency should appreciate against the U.S. dollar, the foreign financed taxpayer will lose on the loan, but the asset financed by that loan will appreciate. This asset appreciation, then, serves as a hedge against a strengthening of the foreign currency.

Foreign-based financing provides a U.S. borrower the added option of being able to time taxable gains or losses by choosing when to refinance a foreign money obligation. In *Willard Helburn, Inc. v.*

60. As discussed *supra* note 1, currency values are in a constant state of flux in international markets. Currency exchange rates reflect much more than the domestic and local economics of the issuer, which are the main influences in the appreciation of real property. *See also infra* notes 61-68 and accompanying text.

Commissioner,[61] the First Circuit held that where a taxpayer had purchased lambskins for use in his manufacturing process with borrowed pounds sterling, which soon thereafter were devalued, the repayment of the loan was a taxable event. The taxpayer either had to adjust its basis in the lambskins or add the gain to its gross income.[62]

A 1978 Revenue Ruling restated the principle that payment of a foreign money loan is a taxable event in regard to recognizing gain or loss.[63] The Revenue Ruling concerned the case of a corporate taxpayer who incurred an obligation in a foreign currency in order to buy equipment, and who realized an almost immediate gain of 20% from a devaluation of that currency. The I.R.S. held that the taxpayer was not required to reflect any gain upon the acquisition of the equipment. The taxpayer instead would have to reflect the gain upon the sale of the equipment by comparing the rate of exchange at the time of purchase and at the time of sale.[64] Moreover, the Revenue Ruling held that the taxpayer realized ordinary income or loss on each installment payment, measured by the original value in U.S. dollars of each portion of the loan principal paid in an installment versus the U.S. dollar value of the currency used to make each repayment.[65]

More recently and specifically, in *American Air Filter Co. v. Commissioner*,[66] "the Tax Court held that, although final repayment of the foreign currency loan is usually the event which closes the transaction for tax purposes, the conversion of a foreign currency obligation into an obligation payable in U.S. dollars is also a taxable event."[67] The Court agreed with the taxpayer who argued that the terminating event in regard to fixing foreign exchange gain or loss was not the final repayment of the loan obligation, but was the act of refinancing the loan from one payable in a foreign currency to one payable in U.S. dollars.[68] Thus, the *American Air Filter* ruling allows a taxpayer to time his gain or loss by domestically refinancing a foreign debt obligation. Such flexibility of gain or loss determination and timing is, of course, unavailable to the domestic borrower.

2. *Income from Rental*

The greatest disadvantage in buying a Canadian rather than a domestic vacation home is with respect to income earned from part-

61. 214 F.2d 815 (1st Cir. 1945).
62. *Id.*
63. Rev. Rul. 78-281, 1978-2 C.B. 204.
64. *Id.*
65. *Id.*
66. 81 T.C. 709 (1983).
67. Ravenscroft, *supra* note 58, at 65.
68. *Id.* at 65-66.

time rental. In general, a nonresident taxpayer must pay Canadian tax on net income received from rental property regardless of the owner's business or nonbusiness ownership purposes.[69]

In the case of nonbusiness property, the taxpayer must elect to pay income tax under section 216(1) of the Canadian Income Tax Act; otherwise, section 212(1)(d) of the act applies a 25% tax to gross revenue without cost reductions.[70] If the 216(1) election is made, the nonresident taxpayer must pay only an income tax under the Tax Act; he pays nothing to the individual provinces.[71] Such federal taxes will be computed at the Canadian resident rate "without abatement . . . and as augmented by the section 120 'surtax' in the case of foreign individuals."[72] Thus, expense deductions are generally disallowed for vacation homes purchased for personal or investment purposes.

Revenue Canada does not subscribe to the United States Internal Revenue Service Code's presumption that rental expenses and rental receipts represent a wash when the rental period is limited to fourteen-days or less. Returning to our hypothetical, Buyer Y, who purchased the Canadian home, would be entitled to a foreign tax credit, just as he would if he paid a land transfer tax.[73] He would, however, still suffer a slight detriment in comparison to Buyer X, as Y's tax deduction in the United States is unlikely to save him as much money as he had to pay in Canadian taxes; even if it did, he would still face an administrative burden in claiming it. This Canadian liability will, of course, affect different taxpayers differently—Buyer Y may not be interested in renting his home out two weeks per year. For many taxpayers, however, this difference between the two countries will be the one factor favoring a purchase inside the United States over one in Canada.

3. *Disposition of Acquired Property*

The alienation of Canadian real property by nonresidents is subject to certain statutory restraints. Government certification is required, and its absence may result in a penalty, or price reduction of the property in question.[74]

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69. Boidman, *supra* note 15, at 380.

70. *Id.*

71. *Id.* But, if the property is located in Ontario and the taxpayer is a nonresident corporation, then para. 2(2)(b) and 2(3)(b) of the Corporations Tax Act, ONT. REV. STAT. c.97 (1980), require an additional corporate tax.

72. Boidman, *supra* note 15, at 380.

73. *See supra* text accompanying notes 48-54.

74. Income Tax Act, ch. 63, § 116, 1970-1972 Can. Stat. 1615, *amended by* ch. 14, § 38, 1973-1974 Can. Stat. 187; ch. 26, § 75, 1974-1975 Can. Stat. 586; ch. 48, § 63, 1980-1983 Can. Stat. 1403; ch. 140, § 74, 1980-1983 Can. Stat. 3952. Section 116(2) applies to proposed disposition, while § 116(3) and (4) apply to the post-disposition period. *See also* Strother, *supra* note 14, at 76.

Canada's "principal residence exemption" may apply, however, with major tax consequences to nonresident holders of Canadian real estate who dispose of such property. As a general rule, gain resulting from the disposition of nonbusiness real property results in capital gains treatment by Revenue Canada. Canadian tax law, however, allows complete or partial deductions from such capital gain if the property sold qualifies as a principal residence.[75] A formula contained in paragraph 40(2)(b) of the Canadian Tax Act determines the degree of tax exemption for such capital gains. The amount of gain realized by the taxpayer is multiplied by a fraction: the numerator is the number of years, plus one, that the property was the principal residence of the taxpayer and the taxpayer was resident in Canada; the denominator is the number of years the property was owned by the taxpayer. This figure is then subtracted from the total gain to arrive at taxable capital gain.[76] The net result is that

> [i]f a taxpayer has ordinarily inhabited the property and has been resident in Canada throughout his entire period of ownership of a dwelling, the whole gain on the disposition of the property will be tax-exempt. *If either the taxpayer was not resident in Canada or the property is not designated as the taxpayer's principal residence for any particular year of ownership, any gain realized on disposition may be only partially exempt.*[77]

While these computations will only fully exempt gain realized by residents of Canada, the U.S. taxpayer should nevertheless note that actual "occupancy of a property for even a short period during a year will meet the 'ordinarily inhabited' requirement, and a property will qualify as a principal residence provided that the primary reason for owning the property is not for the purpose of gaining or producing income . . . ."[78]

V. CONCLUSION

Canadian vacation property investment is better suited to investors who genuinely desire vacation property in Canada for their own personal use, rather than investors who rely on ready transferability of property to gain enjoyment and economic profit from their acquisition. The U.S. taxpayer who purchases Canadian vacation property with that personal motive enjoys economic gain in three ways: (1) possession of a hedge against inflation resulting from a favorable rate of currency exchange; (2) an initial premium over the buyer of domestic

75. Strother, *supra* note 14, at 63. "Principal Residence" is defined in para. 54(g) of the Income Tax Act. *See* Income Tax Act, ch. 14, § 14, 1973-1974 Can. Stat. 132, *amended by* ch. 26, § 25, 1974-1976 Can. Stat. 432; ch. 4, § 14, 1976-1977 Can. Stat. 59; ch. 140, § 23, 1980-1983 Can. Stat. 3841.

76. Strother, *supra* note 14, at 63.

77. *Id.* at 64 (emphasis added).

78. *Id.* at 61.

lands because a favorable rate of exchange allows the U.S. buyer either to purchase more for his dollar, or to spend fewer dollars; and (3) a possible benefit from a form of "secondary appreciation," through an appreciation of the foreign currency in addition to any appreciation of land value.

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