

Estate Tax Update

Owning a U.S. Vacation Property

The estate of a Canadian resident may be required to pay U.S. estate tax on a U.S. vacation home owned by the deceased. However, the Canada-U.S. Tax Treaty (“the Treaty”) provides some relief.¹ As a result, Canadian residents will have a U.S. estate tax liability only if their worldwide assets are valued at more than US\$2 million (US\$3.5 million in 2009).

While U.S. estate tax applies to other U.S. assets, such as U.S. securities, this *Estate Tax Update* discusses the estate tax only as it applies to U.S. real estate. All amounts are in U.S. dollars.

How is U.S. Estate Tax Calculated?

If you own a U.S. property, you will be required to pay U.S. estate tax based on the value of the property at the date of your death. For 2008, estate tax rates start at 18%, and reach 45% for properties worth more than \$1.5 million.

You can reduce your estate tax liability by claiming a tax credit (referred to as the unified credit) equal to the greater of:

- \$13,000; and
- \$780,800 (i.e., the U.S. estate tax on \$2 million of assets) x the value of your U.S. assets ÷ your worldwide assets.

Therefore, if your U.S. home accounts for 15% of the value of your worldwide estate, you will be entitled to a unified credit of \$117,120 (\$780,800 x 15%).

Future estate tax rates and credit amounts

The good news is that the unified credit increases to \$1,455,800 in 2009 (which equals the U.S. estate tax on \$3.5 million of assets). However, unless new legislation is enacted, in 2011 the United States is scheduled to return to its former higher rates and lower exemptions.

Most practitioners believe that the 2009 rates and exemptions will be extended.

	Calendar year			
	2008	2009	2010	2011 and after
Unified credit amount	\$780,800	\$1,455,800	N/A (taxes repealed)	\$345,800
Highest estate tax rate	45%		0%	55%

1. This *Estate Tax Update* addresses the tax issues for Canadian residents who are not U.S. persons for U.S. income and estate tax purposes. For U.S. income tax purposes, a U.S. person is an individual who is a U.S. citizen or U.S. resident alien. For U.S. estate and gift tax purposes, a U.S. person is a U.S. citizen or an individual who is domiciled in the United States.

While nothing is certain, it seems prudent to plan on the assumption that the U.S. estate tax will be around in some form beyond 2009.

Example: The \$1,000,000+ property

Consider Jack, a Canadian resident (who is not a U.S. citizen). Jack owns a Florida home worth \$1.2 million. His worldwide estate is worth \$8 million.

The table below shows how Jack's estate tax liability depends on whether he dies in 2008 or 2009. If the property passes to a Canadian-resident spouse, the Treaty provides further tax relief, through the marital credit. For example, if Jack's will provides that the U.S. property passes to his wife, Vera (who also is not a U.S. citizen), his U.S. estate tax will be reduced, as shown in the bottom two rows:

		Year of death	
		2008	2009
U.S. estate tax before unified credit		\$427,800	
Without marital credit	Unified credit	\$117,120	\$218,370
	Final U.S. estate tax	\$310,680	\$209,430
With marital credit	Marital credit	\$117,120	\$209,430
	Final U.S. estate tax	\$193,560	\$nil

Canadian tax implications

U.S. estate tax is often greater than Canadian tax. On death, a taxpayer will pay Canadian income tax on the accrued capital gain on the U.S. home and will also be subject to U.S. estate tax on the value of the home. Canada may provide a foreign tax credit for U.S. estate tax paid on the U.S. home.

Because Canadian capital gains rates are significantly lower than the top U.S. estate tax rate and Canadian tax applies only to the gain in the property rather than the value, the estate likely will pay tax at the U.S. estate tax rate. In addition, the provinces generally do not allow a foreign tax credit for U.S. estate tax paid. As a result, the deceased may be subject to some double taxation at the provincial level.

Ownership Options Available to Reduce U.S. Estate Tax Exposure

Personal ownership

Personal ownership may be appropriate if the estate tax liability can be managed or eliminated through the credits available under the Treaty. In the case of a married couple, to maximize the unified credit available under the Treaty, the best approach may be to put ownership in the hands of the spouse with the lower net worth. However, the implications of the Canadian income tax attribution rules should be considered.

If the home is owned personally, the individual's will should be reviewed. For example, if Jack's Florida home passes to Vera under his will, Vera will be exposed to U.S. estate tax on her death. A properly structured spousal trust created under Jack's will could eliminate Vera's U.S. estate tax exposure.

Even if the estate tax exposure cannot be fully eliminated, it might be possible to obtain additional life insurance to cover the estimated estate tax. This could be the simplest solution, particularly if the individual is young and has access to low-cost insurance.

Personal ownership in joint tenancy

Many Canadian couples hold property in joint tenancy. However, joint tenancies between spouses who are not U.S. citizens can cause U.S. gift and estate tax problems.

U.S. gift tax may be imposed on the creation or termination of a joint tenancy in U.S. real property. For U.S. estate tax purposes, if the surviving spouse is not a U.S. citizen, 100% of the value of the property is included in the estate of the first spouse to die, unless the executor can prove that the surviving spouse contributed funds towards the purchase of the property. For Canadian tax purposes, no deemed disposition will occur until the death of the second spouse. This can result in foreign tax credit problems.

These U.S. gift and estate complications mean that joint ownership is generally not a recommended form of ownership. As well, joint tenancy may not allow the spouse to undertake effective will and estate planning for U.S. estate tax.

An alternative to joint tenancy may be to hold the property as tenants in common. This could allow each spouse to undertake will planning to protect his or her 50% interest.

Canadian discretionary trust

If the estate tax exposure cannot be dealt with through personal ownership and will planning, the individual may want to consider establishing a Canadian discretionary family trust to own the property. Two key advantages are that:

- estate tax may be avoided on the death of both the individual and the individual's spouse; and,
- if the property is sold, any increase in value will be subject to the same capital gains rates as if the property were owned personally.

This structure generally appeals to Canadians when the property value is over \$1 million and does not constitute a significant portion of the individual's net worth. This is because the individual must be willing to give up control over the property to his or her spouse and children. In addition, due to Canadian income tax rules the trust likely will have to be terminated before its 21st anniversary date. Therefore, the trust structure may not appeal to younger families.

Non-recourse mortgage

A non-recourse mortgage may be an alternative, particularly if the property is already owned by the Canadian. A non-recourse mortgage is collectible only against the specific property and not against any other assets of the individual. For U.S. estate tax purposes, the value of the property is reduced by the value of the non-recourse mortgage. For example, if Jack obtained a non-recourse mortgage of \$700,000, his taxable estate would be reduced to \$500,000. As a result, his U.S. estate tax exposure would be reduced to about \$107,000 in 2008 and \$65,000 in 2009.

In our experience, most commercial banks are unwilling to lend more than 50% to 60% of the value of the U.S. real estate. Therefore, it is unlikely that you can eliminate the total value of the property by obtaining a non-recourse mortgage through an arm's-length lender.

If the non-recourse mortgage is obtained from a non-arm's length party, such as a relative, the arrangement should include commercial interest and repayment terms. The financing cost will have to be considered when comparing this alternative to other ownership arrangements. It may be possible to reduce the financing cost if the mortgage can be structured to obtain an interest deduction in Canada. This means that the mortgage proceeds cannot be used to purchase the U.S. vacation home, but must instead be used to purchase other income-producing investments.

Other options

If personal or trust ownership does not fit the circumstances, more complex arrangements are available, such as:

- ownership through a Canadian corporation;
- ownership through a Canadian partnership arrangement; and
- donation of the property to a U.S. registered charity.

Using a Canadian corporation is no longer popular because the shareholder must now report a taxable benefit for the personal use of the property, and the income tax rate on the sale of the property is significantly higher than if the individual or a trust owned the property.

Another option, the Canadian partnership structure, can be extremely complex. However, it may be worth reviewing if the individual is not prepared to give away the asset during his or her lifetime.

We encourage you to consider your options before entering into a purchase agreement. Many planning techniques cannot be used after the property is purchased, because of U.S. gift tax consequences associated with the transfer of U.S. real estate. We are here to assist. Please call us.

For More Information

If you have any questions about your exposure to U.S. estate and gift tax, please call or e-mail us.

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