Estate tax update

Owning a U.S. vacation home

(Revised edition, February 4, 2013)

If you are a Canadian resident who owns U.S. real estate, learn about your potential estate tax liability and how to reduce it.

This article applies to personal-use properties only.

If you own a U.S. rental property, other considerations should be taken into account.

February 4, 2013

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 now have a U.S. estate tax liability only if their worldwide assets are valued at more than U.S. $5.25 million.**[2]

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 fair market value of the property at the date of your death. Estate tax rates start at 18% and reach 40% for properties worth more than $1,000,000.

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
- $2,045,800[3] 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 $306,870 ($2,045,800 x 15%).

An additional credit is available if the U.S. property passes to a Canadian spouse. The good news is that in many cases these tax credits will eliminate the U.S. estate tax liability. The estate may still be required to file a U.S. estate tax return to claim the credits provided in the Treaty.

Example: The $1,000,000+ property

Consider Steve and Michelle, married and residents of Canada (neither are U.S. citizens). Steve owns a Florida home worth $1.2 million. His worldwide estate is worth $8 million. Steve's estate tax liability on the Florida home, before any tax credits, is $118,930.

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, gift and generation-skipping transfer (GST) tax purposes, a U.S. person is a U.S. citizen or an individual who is domiciled in the United States.
2. The *American Taxpayer Relief Act of 2012* establishes an exemption amount of $5 million and indexes this amount for inflation annually. The indexed exemption amount is $5.25 million for 2013.
3. $2,045,800 is the U.S. estate tax on $5.25 million of assets.

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If the property passes to Michelle, the Treaty provides further tax relief, through the marital credit. As the table shows, the marital credit is sufficient to eliminate Steve's U.S. estate tax.

U.S. estate tax before unified credit		$425,800
Without marital credit	Unified credit	$306,870
	Final U.S. estate tax	$118,930
With marital credit	Marital credit	$118,930
	Final U.S. estate tax	Nil

Additional examples are in the table on page 3.

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 will 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 its fair market value, the estate likely will pay tax at the U.S. estate tax rate. In addition, the provinces and territories 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.

Ownership options to reduce 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 owner's will may need to be changed. For example, if Steve's Florida home passes to Michelle under his will, she may be exposed to U.S. estate tax on her death. A properly structured spousal trust created under Steve's will could protect Michelle from estate tax.

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.

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.[4] If U.S. estate taxes are owing, this can result in foreign tax credit problems.

These U.S. gift and estate complications mean that joint ownership generally is not a recommended form of ownership if an individual will likely have a U.S. estate tax liability. In addition, 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.

4. The Canadian tax regime allows for a tax-free spousal rollover for assets bequeathed to the surviving spouse or a spousal trust.

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 trust 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 a Canadian resident (who is not a U.S. citizen). 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 Steve 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 $28,000 in 2013.

In our experience, most commercial banks would be 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 cost of financing 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

Other available options include:

- ownership through a Canadian corporation; or
- 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.

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.

Examples: U.S. estate tax liability

<table>
<tr><th colspan="2"></th><th>Example 1</th><th>Example 2</th><th>Example 3</th><th>Example 4</th><th>Example 5</th><th>Example 6</th><th>Example 7</th><th>Example 8</th></tr>
<tr><td colspan="2">Value of U.S. property</td><td colspan="4">$500,000</td><td colspan="4">$1,000,000</td></tr>
<tr><td colspan="2">Value of worldwide estate</td><td>$5,000,000</td><td>$7,500,000</td><td>$10,000,000</td><td>$15,000,000</td><td>$5,000,000</td><td>$7,500,000</td><td>$10,000,000</td><td>$15,000,000</td></tr>
<tr><td rowspan="2">U.S. estate tax liability</td><td>With unified credit</td><td>$0</td><td>$19,400</td><td>$53,500</td><td>$87,600</td><td>$0</td><td>$73,000</td><td>$141,200</td><td>$209,400</td></tr>
<tr><td>With marital credit</td><td colspan="3">$0</td><td>$19,400</td><td colspan="3">$0</td><td>$73,000</td></tr>
</table>

For more information

We are here to help. 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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How much tax do you owe?

Use our **Income Tax Calculator for Individuals** to estimate your 2012 tax bill and marginal tax rates. Find it at: **www.pwc.com/ca/calculator.**

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