

## Cheap U.S. vacation property = big estate tax consequences

Beth Webel / January 23, 2009

Lower United States property values and a stronger Canadian dollar have led many Canadians to consider purchasing their dream vacation properties in the southern U.S. However, while owning U.S. vacation property provides a great escape from the often harsh winters of the great white north, it also exposes Canadians to the U.S. estate regime that eliminates a number of estate tax planning options once the purchase is complete.

Without planning, a Canadian's estate may be required to pay U.S. estate tax on the value of their new home. Rates start at 18% and rise quickly to 45% for properties worth more than US\$1.5 million. But thanks to the Canada-U.S. Tax Treaty, there are a number of ways to mitigate the burden.

### How exemptions work

For U.S. citizens, the first US\$3.5 million in assets are exempt from U.S. estate tax. The treaty entitles Canadians to a percentage of that exemption that represents the proportionate value of their U.S. assets, relative to their worldwide holdings.

For example, if U.S. property represents 20% of the client's worldwide assets, the deceased will be entitled to an exemption of \$700,000 [20% of the original \$3.5-million exemption = \$700,000].

The treaty provides additional relief if the U.S. property passes to a Canadian spouse. In general, this provision will double the exemption if all assets pass to the surviving spouse.

While the current U.S. annual exemption is US\$3.5 million in 2009, unless new U.S. legislation is enacted, the exemption drops back to US\$1 million in 2011 and the top 45% rate will revert to the original 55% tax rate. Most practitioners though, believe that 2009 rates and exemptions will be extended. While nothing is certain at this time, it seems prudent to plan and advise clients based on the assumption that significant U.S. estate taxes will be around in some form beyond 2009.

### Personal ownership

Personal ownership may be the simplest way for clients to hold property if the U.S. estate tax liability can be managed or eliminated. The best approach for married couples may be to put ownership of the property in the hands of the spouse with the lower net worth. However, you should consider Canadian income tax attribution rules if that spouse doesn't have his or her own source of funds to complete the purchase. Under these rules, for Canadian tax purposes, it could be assumed the property belongs to the other spouse.

If the home is owned personally, individual wills should be reviewed. It may be possible to eliminate U.S. estate tax if the U.S. property passes to a property structured spousal trust on death.

## Joint tenancy

Joint tenancy — ownership of an asset by two or more persons, each with an undivided interest or ownership right to use and own the property, and the right of survivorship — is a common form of ownership for Canadians. However, joint tenancy for a U.S. property is generally not a recommended form of ownership for Canadian spouses. For U.S. estate tax purposes, the entire value of the property is included in the U.S. estate of the first spouse to die, unless the executor can prove that the surviving spouse contributed funds towards the purchase of the property.

In addition, joint tenancy does not allow for any will planning to take place because the property passes automatically to the surviving partner. Owning the property as tenants-in-common, where share ownership in the property is passed on to heirs in the deceased's will, may be an effective alternative since it allows each spouse to undertake will planning to protect his or her half-interest.

## Canadian trust

If the U.S. estate tax cannot be dealt with through personal ownership and will planning, consider advising clients to establish a Canadian discretionary family trust to own the property. The two key benefits are that:

- ? U.S. estate tax may be avoided on the death of both parties; and
- ? if the property is sold, any increases in value will be subject to the same reduced capital gains income tax rates available to individuals.

Trust ownership generally appeals to Canadians when property values exceed US\$1 million and do not make up a significant portion of the individual's net worth — the individual must be willing to give up control over the property to his or her spouse and children. In addition, because of Canada's 21-year rule, the trust likely will distribute the property to capital beneficiaries before its 21st anniversary, to avoid a deemed realization of accrued gains. With this in mind, the trust structure may not appeal to younger families.

## Non-recourse mortgage

A non-recourse mortgage is another option, particularly if the U.S. property is already owned. A non-recourse mortgage is collectible only against the U.S. property and not against any other assets. For U.S. estate tax purposes the value of the U.S. property is reduced by the value of the non-recourse mortgage. Commercial banks may restrict their lending to 50% or 60% of the property values and it may not be possible to eliminate the entire U.S. estate tax exposure, but other treaty exemptions may further reduce or eliminate the excess value that is subject to the U.S. estate tax.

Financing costs will have to be considered when comparing this option to other ownership arrangements. It may be possible to reduce financing costs if the mortgage interest is deductible. This means that funds from a new mortgage on the U.S. property must be used to purchase income-producing investments if the U.S. home is currently owned and mortgage-free. Consequently, current mortgage financing may need to be restructured to achieve this goal.

## Other options

If the personal or trust ownership does not fit the circumstances for your client, other options can be considered. All though, involve additional complexities that will require thorough review before proceeding. The different options include:

- ownership by or using a Canadian corporation;
- ownership by a Canadian partnership; and
- plans to donate the property to a U.S.-registered charity.

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