BY JAMIE GOLOMBEK

Foreign Property Ownership

How the estate tax affects your client's U.S. vacation property

If your clients are considering purchasing a U.S. vacation property, they are probably wondering about the best way to structure the ownership of such a property. Should they use a corporation or a trust? Or should the property simply be bought in personal name? What about U.S. estate tax?

The good news is that for the majority of Canadians seeking to buy non-commercial U.S. real estate for personal use, such as a Florida condo or an Arizona vacation home, often the best and most cost-effective solution is simply to buy it personally. The biggest concern with personal ownership, however, is the potential application of the U.S. estate tax if you die owning the U.S. property.

Canada, of course, does not have an estate tax. Instead, we tax only the unrealized appreciation of assets (other than your principal residence) upon death, as well as the fair market value of your RRSP/RRIF.

But U.S. citizens living in Canada and non-U.S. citizens who own "U.S. *situs* property" upon death may be potentially caught by the U.S. estate tax.

For U.S. citizens, including dual Canadian/U.S. citizens living in Canada, the U.S. estate tax applies to the fair market value of their worldwide assets upon death. Rates start at 18 per cent and reach 40 per cent once assets are more than $1 million (all numbers in U.S. dollars). But most individuals need not worry about paying any U.S. estate tax, since there is a generous exemption, which was doubled when President Donald Trump signed into law the *Tax Cuts and Jobs Act*. It came into effect on January 1, 2018.

While President Trump's original plan called for a complete repeal of the estate tax, the final U.S. law stopped just short of that. Instead, it doubled the federal estate (and gift) tax exemption, such that it increased to $11.2 million for 2018 (to be indexed annually) from $5.6 million. Technically, the exemption is applied in the form of a "unified credit" against U.S. estate tax payable. For 2018, the credit is valued at $4,425,800, which is equal to the U.S. estate tax payable on $11.2 million of assets.

That means that a U.S. (or dual) citizen would have to have a worldwide estate of more than $11.2 million (or nearly CDN $14 million!) before being subject to U.S. estate tax on death.

For non-U.S. citizens, the estate tax only applies to individuals who die owning U.S. *situs* property. The most common examples of U.S. *situs* property are U.S. real estate, or direct ownership of shares of U.S. corporations, even if held at a Canadian brokerage and even owned inside registered accounts such as RRSPs, RRIFs, and TFSAs.

Canadians who are not U.S. citizens are entitled to a $60,000 exemption under the U.S. domestic tax code or to the potentially more generous prorated exemption under the Canada-U.S. tax treaty. The exemption is prorated by dividing your U.S. *situs* property by the value of your worldwide estate.

Mathematically, this means if you were to die in 2018 and your worldwide estate does not exceed $11.2 million, your estate will get a full exemption from U.S. estate tax regardless of the value of any U.S. *situs* assets. High-net-worth Canadians who die owning U.S. *situs* property and have an estate larger than $11.2 million may still have some exposure to U.S. estate tax.

To see how the math works in the case of high net worth client, let's take a look at the example of Kristine, a Canadian resident (who is not a U.S. citizen), who owns U.S. *situs* property upon death worth $1.5 million. Her entire estate is valued at $15 million.

If Kristine dies in 2018, she would only be subject to U.S. estate tax on the value of her U.S. condo, worth $1.5 million. The estate tax on this amount, before deducting the unified credit, works out to $545,800 by applying the graduated U.S. estate tax rates to the $1.5 million condo value.

But, under the Canada-U.S. treaty, Kristine's estate can claim a pro-rated unified credit equal to $442,580, which is calculated by pro-rating the full credit ($4,425,800) by the ratio of her U.S. *situs* property ($1.5 million) to her worldwide estate (U.S.$15 million) or 10 per cent. Thus Kristine's U.S. estate tax bill would be reduced to U.S. $103,220 ($545,800-$442,580).

If Kristine was married at the time of her death, in addition to the unified credit, Kristine's estate may also claim a marital credit under the tax treaty if the U.S. *situs* asset is left to her surviving spouse on death. The marital credit is equal to the lesser of the unified credit and the amount of the estate tax. If Kristine were to leave her U.S. condo to her husband, who is also a Canadian resident (and not a U.S. citizen), her U.S. estate tax liability would be completely eliminated.

For high-net-worth Canadians, more complex planning is available. This typically involves the use of a Canadian discretionary trust to own the U.S. real estate or obtaining a non-recourse mortgage against the U.S. property. Permanent life insurance can also be a very cost-effective solution to cover the future tax liability.

JAMIE GOLOMBEK, CPA, CA, CFP, CLU, TEP, is managing director, tax and estate planning, at CIBC Financial Planning & Advice. He can be reached at jamie.golombek@cibc.com.

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