Guidance for Canadian snowbirds

By KENNETH LOBO

In increasing numbers, Canadian citizens and residents are purchasing U.S. vacation homes. In counselling these "snowbirds" it is important that the advisor keep several tax and non-tax-related issues in mind, namely probate & incapacity, medical care and insurance coverage, U.S./Canadian income tax and U.S. estate tax

The following will focus on the U.S. estate tax consequences of owning U.S. real property by Canadian snowbirds. However, the other issues mentioned above should not be forgotten and may occasionally outweigh the importance of the U.S. estate tax.

Owning U.S. real property in an individual's name is a preferred option when that individual is not subject to the U.S. estate tax. However, this leaves unresolved the issues of incapacity and probate.

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U.S. estate tax basics

The gross estate for a non-resident non-citizen such as a Canadian snowbird is comprised solely of U.S. situs assets that would be included in such decedent's estate under general estate tax rules. The gross estate tax value is reduced by various deductions to arrive at a taxable estate.

Under the U.S.-Canada income tax treaty, the exemption for Canadian citizens and residents is a taxation of the basic exemption ($5.34 million for 2014) multiplied by a fraction of which the numerator is the gross value of the U.S. situs assets and the denominator is the gross value of the decedent's worldwide estate (determined, solely for these purposes, as though the Canadian decedent were a U.S. citizen). The estate tax rate is a progressive rate, which starts at 18 per cent and rises to 40 per cent for a taxable estate exceeding $1 million.

Another treaty benefit is the marital credit which nearly doubles the pro-rated applicable credit amount. Therefore, an individual whose worldwide estate is valued at less than $5.34 million, or a married couple whose worldwide estate is valued at less than $10.68 million, is not subject to the U.S. estate tax.

As with the Canadian-deemed disposition tax on death, the estate tax may be deferred until the death of the second to die of a married couple. The use of a spousal trust with an "ascertainable standard" can allow the surviving spouse the ability to access income while excluding the assets of the spousal trust from his or her gross estate.

U.S. situs assets

Only assets deemed situated in the United States ("U.S. situs assets") are included in the Canadian decedent's gross estate and are subject to the U.S estate tax. U.S. real estate is considered a U.S. situs asset. Other U.S. situs assets are U.S. stocks and debts of U.S. persons.

Under the U.S-Canada income tax treaty, there exists a reciprocal foreign death tax credit.

Thus, if a Canadian estate must pay the U.S. estate tax on a U.S. situs asset, that tax is creditable against the Canadian federal capital gains on the same asset. Since the U.S. estate tax is often higher than the Canadian capital gains tax, there may still be some U.S. estate tax due.

There are three methods of holding title to U.S. real property: individual name, corporate/partnership ownership and trust ownership.

Individual name ownership

Owning U.S. real property in an individual's name is a preferred option when that individual is not subject to the U.S. estate tax. However, this leaves unresolved the issues of incapacity and probate.

• Beneficiary deed/enhanced life estate deed: Holding title in the name of a beneficiary deed/enhanced life estate deed is common in certain U.S. states. Generally, such deeds will avoid probate, but will not exclude the U.S. asset from the decedent's gross estate. There may be a U.S. gift tax and a Canadian-deemed disposition of a property interest when additional owners (i.e. children) are added to the title of the property after the property is already owned. Care must also be taken to plan for any Canadian attribution issues during the purchase of the property.

• Will Planning: As mentioned above, if a legally married couple's estate is valued below $10.68 million, they may choose

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to take title in the name of one individual or as tenants in common with each individual owning 50 per cent of the property. On the first spouse's death, what he or she owns would pass to a spousal trust for the benefit of the surviving spouse. If the will is properly drafted, the property held in the spousal trust will not be subject to the U.S. estate tax when the surviving spouse dies.

• Insurance: The property owner may purchase life insurance to pay an expected U.S. estate tax liability. Note that if the policy is owned personally, the death benefit will be included in the decedent's denominator, thus increasing the decedent's taxable estate. To avoid such treatment, the life insurance may be purchased in the name of an irrevocable life insurance trust.

Corporate/partnership ownership

• Canadian corporation: If a Canadian corporation owns the U.S. real property, the Canadian shareholder will not own U.S. situs assets, and consequently, there will be no U.S. estate tax owed when the shareholder dies. However, the personal use of the U.S. real property will result in the shareholder being subject to tax in Canada on an amount equal to the fair rental value of the property. Furthermore, any income earned by the corporation is subject to the U.S. corporate tax (up to 35 per cent) and possible state corporate tax as well. These rates are higher than U.S. capital gains tax rates for individuals or trusts.

• Partnership: Canadian individuals who are limited partners of a limited partnership will be treated as if they directly own the partnership's U.S. situs assets, and upon their deaths, such assets will be included in their respective gross estate(s), proportionately. Practitioners are divided as to whether a multi-tiered partnership formed in separate countries will exclude U.S. situs assets from a decedent's gross estate and consequently, caution must be used when using such structures.

• Limited liability corporation: An LLC is a U.S. entity whereby under U.S. law, the owner is taxed directly on any income earned by the LLC. However, in Canada, the LLC is treated as a corporation and is consequently denied treaty benefits. In other words, income earned by the LLC will be taxed in the U.S. and an offsetting credit will not be available for that same income in Canada, resulting in double taxation. Therefore, ownership of U.S. real property by a LLC by a Canadian snowbird should generally be avoided.

Trust ownership

• Use of a bare trust-U.S. revocable trust: Used by some Canadian firms, these hybrid entities are intended to avoid both probate and incapacity but will not exclude the U.S. asset from the decedent's gross estate. Practitioners should weigh the cost of the hybrid trust against the cost of probate and may choose one of the alternative methods discussed above, which may accomplish the same goal in a more cost-effective manner.

• Use of a family trust: A properly drafted irrevocable family trust will exclude the trust's assets from the U.S. estate tax, provided that the trust acquires the property initially. Because the trust is a Canadian resident, there will be a deemed disposition after 21 years which must be planned for. It should be noted that if the non-contributing spouse dies first, the surviving contributing spouse must pay fair market value rent to the trust if he or she continues to reside there.

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