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CHEAP REAL ESTATE COMES WITH STRINGS

By Helen Burnett | Publication Date: August 2008
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With the dollar hovering around par for the last year or so, and the U.S. housing market offering good deals, Canadians are heading south to buy vacation homes in greater numbers than ever.

CORRECTION: *In the article "Cheap real estate comes with strings" in the September 2008 issue of* Canadian Lawyer*, Mary Anne Bueschkens was incorrectly paraphrased as saying that, until 2005, Canadians purchasing U.S. real property could avoid U.S. estate tax when they passed away through owning shares of a U.S. company rather than the property. In fact, it is through ownership of shares in a Canadian company rather than the U.S. property that Canadians could avoid U.S. estate tax.* Canadian Lawyer *apologizes for the error.*

This can mean cross-border estate tax implications when individuals own property and U.S. securities, say lawyers who specialize in estate planning.

According to the recently released RE/MAX recreational property report, the dollar, as well as the American housing market meltdown, created serious investment opportunities for Canadians to buy secondary properties south of the border. “Many Canadians are capitalizing on market conditions in major American centres,” noted Michael Polzler, executive vice president and regional director, RE/MAX Ontario-Atlantic Canada. “For some purchasers, the move is strictly a short-term investment strategy with a payoff at the end of the day, while for others, retirement is the main objective.”

Elaine Reynolds, a tax and estate planning lawyer with Legacy Tax & Trust Lawyers in Vancouver, says as the dollar improves she has also seen a lot more Canadians investing in vacation homes in the U.S. “Now, they’re almost on par, so the cost of the Palm Springs or Florida or Arizona condo has dramatically dropped, from a Canadian tax perspective,” she says. However, she says, when people go to invest, even as non-resident aliens, that vacation property is subject to U.S. estate tax when the Canadian citizen or resident passes away.

There has always been a migration of people — think Snowbirds — going to the U.S., says Reynolds. When the U.S. dollar was close to $1.60, she says, it was more of a burden for people, as the monthly liability became expensive. Now, not only has the cost of places come down, but the monthly maintenance is not as prohibitive.

“You kind of have to remember that as the dollar gets better, your investment grows in value, but your liability to pay all these expenses grows and that becomes really bad in particular if it’s mortgaged,” she says.

“Many smart Canadians have realized that there’s a window of opportunity today with a strong loonie and a soft U.S. market,” says David Altro, senior partner at David A. Altro & Associates LLP, a Florida lawyer and Quebec legal counsel whose firm specializes in representing Canadians with U.S. assets. As a result, his firm is busy structuring purchases, doing the real estate transactions, and dealing with the tax and debt issues.

At the moment, says Altro, if the U.S. property is over $60,000 and worldwide assets are over $2 million, there may be U.S. estate tax when the owner dies, even though the person is a Canadian citizen and resident. The tax is significant, says Reynolds, kicking in at $2 million of value with a top rate of 45 per cent. “If your worldwide assets including your U.S. vacation home are $2 million or less, you will still be not subject to the U.S. estate tax, because under the formula you’ll still get the full credit. When you run into the problem is when somebody’s worldwide assets are worth more than $2 million and they have U.S. assets in the mix,” she says.

A non-resident of the U.S only gets a $13,000 credit, which shelters $60,000 of taxable estate in the U.S., says Reynolds. Canadian residents can claim the unified credit, equal to the greater of $13,000 or the U.S. estate tax on assets of $2 million, multiplied by the value of U.S. assets, divided by the value of worldwide assets, according to PricewaterhouseCoopers. The exemption is set to go up to $3.5 million in 2009, says Reynolds.
While the U.S. estate tax is set to be repealed for 2010, it will then revert to the law in effect in 2001, which had only a $1-million exemption and a top rate of 55 per cent.

While each case is different and dependant on facts, “planning is not at all straightforward where a client has assets in excess of the exemption amount and some of those assets consist of U.S. property,” notes Reynolds.
Altro says that there are many clients who are not aware of these types of issues. “The majority are not aware of it and even

the Canadian tax lawyers or general lawyers, and accountants generally, are not familiar with it because they don't specialize in U.S. [law]." He says his firm always works with the local accountants or lawyers to explain what goes on so everybody understands and they can create the best structure for the client based on their situation.

Mary Anne Bueschkens, a lawyer with Heenan Blaikie LLP in Toronto and deputy chairwoman of STEP Canada (the Society of Trust and Estate Practitioners), says a lot of Canadian clients are buying property in places like Arizona at the moment. "Normally when they come to see you, the buzzword that they're still thinking about is the single-purpose corporation for purchasing property, which really doesn't work anymore," she says.

The single-purpose corporation used to be the "mechanism of choice" for Canadians purchasing U.S. real property, says Bueschkens, as the underlying premise was that Canadians would avoid U.S. estate tax when they passed away through owning shares of a U.S. company rather than the property. The problem is that there was always an underlying issue in that there was a "shareholders benefit" to Canadians under a section of the Income Tax Act, says Bueschkens, and the relief was taken away in 2005, with a grandfathering for structures already in place.

"The type of ownership of choice right now for clients that are Canadian citizens and residents who are purchasing U.S. real property is to use a trust," says Bueschkens. In addition to trusts, one way that clients deal with this issue is through a non-recourse mortgage, which Bueschkens says is difficult to get.

Clients also have to be careful of owning things jointly. Such ownership is popular north of the border, says Bueschkens, but "a lot of people from Ontario, they'll just buy a house jointly in the United States, not realizing that for U.S. purposes it's not a smart thing to do." For U.S. estate tax purposes, she says, with a joint ownership, all of the property is included as part of the estate in the first person's death and again upon the second person's death.

Altro also says he doesn't recommend limited partnerships, putting the property in a Canadian corporation, or Canadian discretionary family trusts.

Clients also often feel that owning U.S. securities doesn't expose them to U.S. estate tax, says Bueschkens, but they can if the client owns amounts that are over the exemption. This is an issue that is coming up more and more, and a corporation could be used in this circumstance, she says.

The moment you add in U.S. securities as well as real property, says Bueschkens, "then I think there are a lot of clients whose numbers start to really get up there," she says, in terms of estate tax.

It's not that clients aren't aware of the U.S. estate tax rules, says Reynolds, as you see the issue referred to in publications, and most people who invest in U.S. real property know that there is some planning involved. She says she receives most of her referrals from either accountants or financial planners.

Ultimately, Reynolds says she gets the clients in and asks them what they own worldwide, what they each own, what they own jointly, and calculate treaty credits. It can become very complex. "There is not an easy fix and I guess the best advice is to get planning well in advance of purchase," she says, although she adds that many clients call after they've got the purchase contract in place and then the lawyer has to see if there's anything else they can do.

"Buying property in the States today, real estate is a bit of a tricky thing, because there's a lot of property that is in foreclosure, has tax liens, maybe the builder, if you're buying new, is bankrupt, so one thing the buyer should make sure is they have a good real estate attorney, and, of course, we're busy with that also," says Altro.