

# The Canadian way

David Altro discusses new tax issues relating to Canadians owning US real estate



#### ABOUT THE AUTHOR

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This article will look at the various tax and estate planning issues facing Canadians with special emphasis on the major impact of changes in the US estate tax rules under the US Internal Revenue Code (the Code) affecting Canadians. As of 1 January 2010, a Canadian owning US assets upon death in 2010 will not be subject to any US estate tax. 'US assets' for Canadian residents include US real estate and shares of stock of US corporations held personally.<sup>1</sup>

The gift tax rate drops from 45 per cent to 35 per cent. Beneficiaries no longer enjoy a step-up in the basis at death. Instead, the beneficiaries' basis in inherited property equals the lesser of the decedent's basis or the fair market value of the property on the decedent's date of death.

US estate tax comes charging back in 2011. Should a Canadian pass away in 2011 owning US assets there will be tax if the value of the US assets exceeds USD60,000 and the value of the worldwide estate exceeds USD1,000,000. The estate tax rate will be 39 per cent to 55 per cent (with a 5 per cent surcharge for estates that exceed USD10,000,000 – up to about USD17,000,000). The gift tax rate will be 39 per cent to 55 per cent. Stepped-up basis returns, so the beneficiaries receive a new basis in inherited property equal to the fair market value on the date of the decedent's death.

#### Formula for exemption non resident Canadians

US Situs Property X Current Exemption  
Total World Estate

Example: Bob has personally owned a USD750,000 condo in Naples, Florida since 2009. Bob and his wife, Bev, are Canadian citizens residing in Toronto. Bob's worldwide estate is USD8,000,000 and Bev's is USD800,000. Their daughter, Amanda, is a physician residing in Boston with her US husband and their children. Bob's son, Steve,

is a businessman living in Toronto with his wife Sheila, who is a US citizen.

#### Is Bob's estate subject to US estate tax?

If Bob passes away in 2010 his US estate, being the Naples condo, will not be subject to any US estate tax. However, if Bob passes away in 2011 his estate will be subject to a US estate tax of USD215,881.

If Bob died prior to Bev his estate could elect the 'marital deduction', which would save USD32,419 of the tax if he leaves his US estate to his wife. Alternatively, his estate could defer the tax until the earlier of the sale of the property by Bev or her subsequent death by creating a Qualified Domestic Trust (QDOT).<sup>2</sup>

#### The times they are changing

Under the 2009 rule a Canadian resident who passed away having a worldwide estate of under USD3,500,000 would be exempt from US estate tax on the US assets. In 2009 numerous bills were introduced in Congress and Senate to amend the US estate tax. However, none passed both Houses. While President Obama campaigned for presidency, his tax platform included extending the USD3,500,000 exemption long term. Surprisingly, it has not happened. Is it possible that a bill will pass into law in 2010 changing the US estate tax? It might and it could be retroactive to 1 January 2010.

#### How should we advise our clients?

Let's start with asking our clients what assets they own in the States and elsewhere. Next, it is important to advise the clients as to the current situation with US estate tax and the potential for change. However, for Bob, it does not really matter whether the estate tax has an exemption of USD1,000,000 or USD3,500,000. His estate will have a tax problem.

There are also other problems for Bob upon death. His Florida estate will be subject to Florida probate. This is expensive and time consuming while freezing the estate. Probate fees and costs could easily run to USD20,000,

while tying up the property in probate.

Firstly, we should transfer the property out of Bob's personal name into a 'Cross Border Trust'.<sup>SM</sup> This will avoid Florida probate upon Bob's death, and will also avoid guardianship procedures if Bob becomes incapacitated. Upon his death the property will transfer to his beneficiaries but will bypass the probate procedure. Transferring title to his cross border trust can be effected by a tax free rollover without triggering capital gains tax in the US, the deemed disposition rules under the *Income Tax Act of Canada* and land transfer tax.

This trust should also provide a foreign credit in Canada and for the US capital gains tax payable upon sale of the appreciated value property. However, it may not avoid the US estate tax as trusts are typically looked through by the Internal Revenue Service to the beneficiary. But it will defer the tax by the QDOT if Bev survived him.

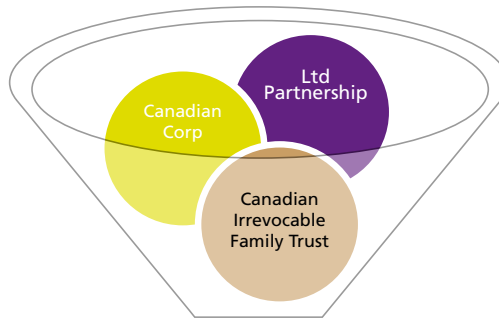
Why not transfer the property to a cross border trust that Bev would own rather than Bob? If Bev died thereafter her estate would be USD800,000. This is below the 2011 exemption of USD1,000,000 on worldwide values. Therefore there would be no US estate tax on Bob or Bev's death.

#### Avoiding the US gift tax

If Bob gives the property to Bev or to a cross border trust owned by Bev, it is a US taxable gift (gift tax exemption of USD133,000 to spouse). To avoid this, why not make a sale to Bev for USD750,000? Bev could pay by promissory note to Bob with interest at the prescribed rate of 1 per cent per annum to avoid the Canadian 'attribution rule' upon sale.<sup>3</sup>

The 'attribution rule' means that if Bob gifted the property to Bev then it is Bob who would pay the Canadian capital gains tax on the sale rather than Bev. This would result in double taxation as Bev would owe the US capital gain tax. However, with the promissory note, it would be Bev who declares the gain in Canada also and who receives a full foreign credit in Canada under the United States – Canada Income Tax Treaty for the amount of the US capital gain

## Update on other strategies to avoid US Estate Tax



tax paid,<sup>4</sup> provided the trust includes the appropriate clauses.

To complete the above plan, certain critical changes are needed in Bob's Canadian will to ensure he does not leave his estate outright to Bev. If he did, she would now have an estate worth almost USD9,000,000. If she passes away thereafter while owning the US property, she would have a huge amount of US estate tax. Bob needs to re-draft his will with a US-compliant cross border spousal trust to avoid inclusion of Bob's estate into Bev's personal estate upon her death.

### Changing the facts will change the plan

What if Bob's estate was USD3,000,000 instead of USD8,000,000? If he dies in 2011 his US estate tax would be USD161,850 less a marital deduction of USD86,450. I would recommend transferring the property to a cross border trust owned by Bob to avoid the probate problems upon death and guardianship procedures if Bob became incapacitated and Bev needed to sell the property.<sup>5</sup>

But what if the USD3,500,000 exemption went back in to effect? There would be no US estate tax on Bob's death. So, Bob is on the bubble. We might wait during 2010 to see whether there is a change in the tax exemption before creating an expensive and complex estate plan.

### Bob's other tax issues

Let's be nice to Bob. Give him back his USD8,000,000 worldwide estate. Now, let's help Bob do a favour for his daughter Amanda in Boston. Amanda and her husband have an estate of USD10,000,000. Upon the death of Bob and Bev, Amanda may inherit USD4,000,000. If Amanda dies in the future without spending the USD4,000,000, which grew to USD6,000,000, what would be the US estate tax treatment on such inheritance at her death? Her estate would probably pay tax at 55 per cent on the USD6,000,000. The entire amount of tax could be avoided by Bob

creating a special cross border dynasty trust for the benefit of Amanda. Assets would then be exempt from US estate tax upon Amanda's death and the subsequent deaths of her descendents. Such a trust is valid in Florida for 300 years.

For Bob's daughter-in-law Sheila, the US citizen married to Steve, the planning should be in Steve's will to create a cross border dynasty trust for the benefit of Sheila's estate and descendents.

### Corporation

This avoids probate and US estate tax upon death. But you can't get a mortgage loan on the property. The combined IRS and Florida Department of Revenue capital gain tax rate is approximately 40 per cent upon sale. The shareholder is obligated under the *Canadian Income Tax Act* to include the value of the use of that property (the rental value), which must be added to the annual income in Canada.

### Limited Partnership (LP)

This avoids probate. It gets the lower capital gains tax rate of 15 per cent upon sale if the limited partner is an individual. But the IRS has a 'look-through' rule and may apply the US estate tax to the individual limited partner of the partnership. We sometimes create a two-tiered LP or an LP owned by a cross border irrevocable trust. A limited partnership is expensive to establish, may have annual reporting requirements and US banks don't lend to limited partnerships on personal use properties.

### Canadian family discretionary trust

This avoids US estate tax on death, avoids incapacity/guardianship procedures and gets the low capital gain tax rate. But a mortgage is not available with this type of trust; it should only be considered on purchase. Legal control of the property is lost since you cannot be in this trust. Purchase money should not come from you. It is subject to the 21 year deemed

disposition rule, triggering a capital gain tax at such time where the property had increased, unless the property is distributed.

### The non recourse mortgage

What if Bob had a standard Florida mortgage on the property for USD500,000 and dies? Would the IRS allow a credit for the mortgage and agree that his taxable estate is USD250,000? Unfortunately, for a Canadian resident, the answer is no. However, there is a way of getting that dollar for dollar deduction for the value of a mortgage upon death. It is a non recourse mortgage. Generally American banks do not offer it as their customers are American residents whose estates do get the deduction. We have been successful in developing a non recourse mortgage product structure for RBC Bank for Canadians with US real estate. This strategy reduces and/or eliminates US estate tax. Coupled together with the cross border trust, Bob and Bev's family may avoid the hassles and expenses of US estate tax, probate expense and guardianship issues, thereby preserving the value of their estate for their beneficiaries. ■

1. A partial list of exempt assets includes US banking and savings and loan deposits including CD's, savings accounts and money market funds; US treasury bonds, notes, bills and agency issues, if issued after July 18, 1984; US corporate bonds if issued after July 18, 1984; specially structured mutual funds; some investment company or brokerage house money market funds and life insurance on death proceeds.
2. We often create a Qualified Domestic Trust with a Cross Border TrustSM (See D. A. Altro, "Owning US Property the Canadian Way" (2009)).
3. Bev must pay interest annually from her own funds and Bob must declare such income to the C.R.A.
4. 15 per cent rate in the US for long term holding – more than 12 months.
5. The Cross Border TrustSM will also protect Bev's estate from estate tax upon her subsequent death.