RBC Wealth Management Services

The Navigator

U.S. Estate Tax: Canadians Owning U.S. Real Estate

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Strategies to minimize or potentially eliminate your exposure

A warmer climate and Canada's close ties to our American neighbours make the idea of owning U.S. real estate for personal or investment purposes appealing. Many of the important income tax considerations of buying U.S. real estate are covered in a separate article (Owning and Renting Property in the U.S.) available from your RBC advisor. In this report we take a closer look at the U.S. estate tax exposure for Canadians with ownership in U.S. real estate.

Overview

If you own U.S. real estate or other U.S. situs assets at the time of your death, your estate may be subject to a substantial U.S. estate tax liability. For deaths in 2014, U.S. estate tax may apply when the value of a Canadian's worldwide estate exceeds US$5.34 million, and their U.S. situs property (including U.S. real estate) is valued at more than US$60,000. U.S estate tax is based on graduated tax rates where the maximum tax rate of 40% applies to the value of U.S. situs assets that exceed US$1 million. Note: If U.S. estate tax does not apply because your worldwide estate is below the threshold, your estate must still file a U.S. estate tax return if the value of your U.S. situs assets at death are greater than US$60,000. For a general discussion of U.S. estate tax for Canadians, ask your RBC advisor for a separate article (U.S. Estate Tax for Canadians).

Of course, Canadians that visit the U.S. and stay in a rental property will not increase their exposure to U.S. estate tax. Renting instead of owning can provide a greater opportunity for exploring different locations in the U.S. and may even help in determining preferable locations to vacation or to make an investment. However, if you are a Canadian who prefers to own U.S. real estate, the potential exposure to U.S. estate tax may lead you to question how ownership should be structured. This article examines how ownership of U.S. real estate through the following ownership structures may impact your exposure to U.S. estate tax:

With a non-recourse mortgage, the full amount of the loan is deductible against the value of your U.S. situs assets that are subject to U.S. estate tax.

- Sole Ownership
- Joint Tenants With Rights of Survivorship (JTWROS)
- Tenants in Common
- U.S. Revocable Living Trust (RLT)
- Canadian Corporation
- Canadian Partnership
- Canadian Trust

In addition, this article discusses two strategies for minimizing exposure to U.S. estate tax: using a non-recourse mortgage; and purchasing life insurance to cover estimated estate tax liabilities. A table summarizing the different ownership options is provided at the end of the article for quick reference.

The information provided in this article is presented in a simplified format. The strategies, guidance and technical content are intended for the exclusive benefit of our clients and are for information purposes only. This article is not intended to be legal or tax advice. Speak to a professional cross-border advisor specializing in tax and estate planning before acting on any of the strategies discussed in this article to ensure your specific circumstances are taken into account.

Sole Ownership

Direct ownership of U.S. real estate may be the simplest and least costly structure to implement. However, direct ownership provides the least amount of protection. For example, in addition to your potential exposure to U.S. estate tax, there may also be exposure to U.S. probate tax when property is held in sole name. As well, without further planning, administrative delays in dealing with U.S. guardianship issues may result in the event that the sole owner becomes incapacitated.

To minimize your exposure to U.S. estate tax you may be able to claim a marital credit if U.S. real estate and other U.S. situs assets are left to a surviving spouse or properly structured spousal trust upon your death. Refer to the separate article mentioned earlier (U.S. Estate Tax for Canadians) if you would like further information regarding the marital credit.

If U.S. estate tax exposure is still present, two other potential strategies (implementing a non-recourse mortgage and purchasing life insurance) may be used to minimize your exposure due to direct ownership.

Non-Recourse Mortgage

U.S. estate tax rules allow for the deduction of debts in determining your U.S. estate tax liability. However, with a conventional mortgage, only a prorated portion of the loan is deductible based on the ratio of your U.S. situs assets to your worldwide estate. With a non-recourse mortgage, the full amount of the loan is deductible against the value of your U.S. situs assets that are subject to U.S. estate tax. This is because the debt is collectable only against the property itself and not against any other assets. If the value of the property is reduced by the full amount of the non-recourse mortgage, your exposure to U.S. estate tax may be reduced or eliminated.

There is also an opportunity for Canadian tax purposes to reduce the taxable income on your Canadian tax return with the interest paid on the non-recourse mortgage. This would apply where a non-recourse mortgage is implemented to refinance the purchase of real estate owned "free-and-clear". The interest will be deductible only when the loan proceeds are used to purchase income producing investments, such as stocks,

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bonds, mutual funds, etc. that pay interest or dividends.

Keep in mind, there is a greater cost to implementing a non-recourse mortgage than a conventional mortgage. Furthermore, if the property has increased in value since the non-recourse mortgage was acquired (and no further refinancing is obtained) the deduction will only partially offset the value of the property for U.S. estate tax purposes and a liability may still result.

Speak to your professional cross-border tax advisor to determine whether a non-recourse mortgage is right for you.

Life Insurance

In some circumstances, purchasing life insurance may be a very cost effective strategy to deal with your potential U.S. estate tax liability. Generally, life insurance policies provide a tax-free death benefit that can be used to cover your U.S. estate tax liability. The cost effectiveness of this strategy depends on the cost of the premiums, which will be based on the status of your health, and the coverage selected.

It is important to understand that the proceeds of a life insurance policy must be included in the value of your worldwide assets at death for U.S. estate tax purposes. This could actually increase your exposure to U.S. estate tax. However, you can minimize this exposure by purchasing a life insurance policy through an Irrevocable Life Insurance Trust (ILIT). Since the ILIT will own the policy and not you, the death benefits paid upon your death will not factor into the calculation of your U.S. estate tax. Further information on the use of ILITs to reduce U.S. estate tax exposure is provided in the separate article (U.S. Estate Tax for Canadians). Ask your RBC advisor for a copy.

Speak to your cross-border tax advisor for more information on whether it makes sense to incorporate an ILIT into your estate plans.

Joint Tenants With Rights of Survivorship (JTWROS)

Many Canadian couples (not applicable to Quebec residents) own property as JTWROS. For ownership of U.S. real estate, owning the property jointly avoids exposure to U.S. probate and administrative delays in dealing with U.S. guardianship issues in the event that one of the joint tenants became incapacitated.

Ownership of U.S. real estate as JTWROS may be desired when minimal or no exposure to U.S. estate tax is expected. For example, you may assess that no exposure exists because the value of the U.S. situs assets or worldwide estate of each joint holder is below the U.S. estate tax thresholds and you expect that this will be the case even when the surviving joint owner takes complete ownership of the property. However, you should take into consideration the following: 1) the U.S. estate tax thresholds could change if new legislation is enacted in the future, 2) when the first joint owner dies, 100% of the value of the property is included in their estate unless evidence is provided to show the other joint tenant contributed funds; and, 3) if only one person contributes the funds to make the purchase U.S. gift tax may apply on the acquisition.

If you estimate there is exposure to U.S. estate tax on the death of any joint tenant, ownership as JTWROS is not recommended because the property may be subject to U.S. estate tax twice in the same generation. For example, a married Canadian couple own a property in Arizona jointly and each contributed 50% to make the purchase. As a result, half of the fair market value of the property is subject to U.S. estate tax when the first spouse dies. The deceased spouse's half interest in the property automatically transfers to the surviving spouse, therefore, there is little opportunity to apply estate planning strategies (such as transferring the property to a trust) to minimize U.S. estate tax. When the surviving spouse dies, the full value of the property is subject to U.S. estate tax. Note: There is a credit that may reduce the U.S. estate tax of the surviving spouse if he/she dies within 10 years; however, the credit is significantly reduced on a sliding

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scale after 2 years. You should consider whether it makes sense to sever the joint tenancy based on each tenant's contributions and hold your respective interests as tenants in common.

There are also differences in Canadian and U.S. income tax rules that may result in double taxation. For example, if real estate held in JTWROS (where one spouse contributed all the funds to make the purchase) is sold, U.S. income tax law may require each spouse to report 50% of the capital gain. However, the capital gain earned for Canadian income tax purposes may be subject to the Canadian income attribution rules. These rules require the spouse who provided all the funds to make the purchase, to report the capital gain without the ability to claim a foreign tax credit for the U.S. income tax paid by the other spouse. If the property is used to earn rental income, the same tax issues may result in double taxation with respect to the rental income earned.

You should speak to a cross-border tax advisor to determine whether any strategies can be implemented (before the property is sold or rental income is earned) to minimize double taxation, such as having the interest in the property transferred to the spouse who provided all the funds.

Tenancy in Common

Tenancy in common is a form of co-ownership where each tenant may own an equal or unequal share of the property. On the death of a tenant, their interest in the property does not pass to the surviving tenants, but rather passes through their estate according to their Will or intestacy legislation.

Only the deceased tenant's share in the property is subject to U.S. estate tax, not the full value of the property. Note that a divided interest in the property is less marketable than a sole interest, so each co-owner may apply a valuation discount when determining the fair market value of their respective share of the property for U.S. estate tax purposes. Some legal experts suggest that it is reasonable to reduce the fair market value of the property by approximately 15-20%. This reduction will decrease the value of your taxable estate and may reduce your exposure to U.S. estate tax. The non-recourse mortgage or life insurance strategy discussed earlier may also be considered where exposure to U.S. estate tax still exists.

The same income tax issues (double taxation) discussed earlier for ownership in JTWROS may apply where one spouse provides the funds to the other spouse to purchase the property as tenants in common. There are also other issues to consider when the property is held tenants in common, especially when held with children and other family members. For example, a tenant in common can sell his or her share in the asset to a third party, mortgage his or her interest, use it as collateral for a loan, or gift it to someone else without requiring the consent of the other tenants. In addition there is exposure to U.S. probate tax, and without further planning, administrative delays may result in dealing with U.S. guardianship issues in the event that the tenant becomes incapacitated.

U.S. Revocable Living Trust (RLT)

If you hold U.S. real estate as tenants in common, some U.S. legal experts suggest using a U.S. revocable living trust (RLT) to hold each individual tenant's interest.

Holding your interest in the property

If the U.S. real estate held inside a Canadian corporation is U.S. vacation property, it is possible that the IRS may be of the view that the corporation is insulating the property (that is for personal use) from U.S. estate tax.

in a RLT will not eliminate your exposure to U.S. estate tax; however, you may consider using a non-recourse mortgage to minimize your exposure to U.S. estate tax. Alternatively, you may consider purchasing life insurance to cover your contingent U.S. estate tax liability.

A properly structured U.S. RLT may eliminate exposure to U.S. probate and administrative delays in dealing with U.S. guardianship in the event that a spouse becomes incapacitated. It may also protect beneficiaries against creditors and, in the case of marriage breakdown, prevent a beneficiary's divorcing spouse from realizing rights to the property.

Some legal experts indicate that with a properly structured U.S. RLT, each spouse's interest in the property may be transferred to the RLT without triggering U.S. gift tax and the Canadian deemed disposition rules.

A more detailed discussion of the use of RLTs is beyond the scope of this article. You should consult with a professional cross-border advisor for more information and advice on whether this strategy is appropriate for you.

Canadian Corporation

If you currently use a Canadian corporation to hold a U.S. real estate, or if you are considering this type of ownership structure for your purchase, you should be aware that this may not be a desirable ownership structure from a U.S. estate or income tax perspective.

If the U.S. real estate held inside a Canadian corporation is U.S. vacation property, it is possible that the IRS may be of the view that the corporation is insulating the property (that is for personal use) from U.S. estate tax. As a result, the IRS may disregard the structure and consider the property to be a U.S. situs asset of the shareholder. This may be the case, particularly if the shareholder transferred the property to the corporation, the real estate is the corporation's only asset, the property is only used by the shareholder and his or her family, and/or corporate formalities are not followed. There is a lower risk that the IRS will disregard the structure where U.S. rental property is held in the corporation provided the corporate formalities are followed.

There are negative Canadian and U.S. income tax issues to consider. For U.S. income tax purposes, the capital gain triggered on the sale of U.S. real estate held in a Canadian corporation will be subject to a U.S. tax rate of up to 35% federally because it does not qualify for the 15% - 20% preferential long-term capital gain rate. The preferential rate is available to individuals, trusts, estates and partnerships that own the real estate for more than a year. In some states, such as Florida, individuals are not subject to income tax, but corporations are and this can add a few additional percentage points of tax onto the sale. It is also worth noting that many U.S. condominium associations do not permit ownership by a corporation.

From a Canadian tax perspective, if you own U.S. vacation property in a Canadian corporation, the Canada Revenue Agency (CRA) may also assert that using such assets held by a corporation, rent-free, represents a taxable shareholder benefit to you. This benefit would be included as taxable income on your income tax return. There is an administrative exception to this CRA policy only if you had established a Canadian corporation on or before December 31, 2004 for the sole purpose of holding U.S. vacation property for use by you and your family. The Canadian shareholder benefit rules may not apply where a U.S. rental property is held in a Canadian corporation; however, there are negative income tax issues to consider. For example, capital gains on the sale of the rental property do not qualify for the preferential capital gains rate and double taxation will result due to U.S. taxation of rental income earned by the Canadian corporation and Canadian taxation of distributable profits (dividends) to shareholders. As a result, other ownership structures may be more appropriate.

Speak to a qualified cross-border tax advisor, if you own or intend to purchase U.S. real estate in a Canadian

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corporation, especially U.S. rental property.

Canadian Partnership

Some experts suggest owning U.S. vacation property in a Canadian partnership with a family member instead of using a Canadian corporation. This more complex strategy may make it possible to treat the Canadian partnership as a corporation at your death for U.S. tax purposes, using what are referred to as "check the box" rules. This may potentially eliminate your exposure to U.S. estate tax, as you will be considered to own shares of a Canadian corporation rather than the U.S. vacation property. The IRS, however, may ignore this structure if it does not have a business purpose. They may consider that the sole activity of the partnership is to hold the U.S. vacation property and not to carry on a business. They may also assert that the partners have retained an interest in the property and have a right to redeem their partnership interest in exchange for the property. If a U.S. rental property is held by the partnership it may be easier to support a business purpose and thus there is a much lower risk the IRS will ignore the structure.

For Canadian income tax purposes, the structure will still be considered a partnership even if it is treated as a corporation for U.S. tax purposes. Therefore, some of the negative Canadian tax consequences of owning U.S. vacation property inside a corporation may be avoided. However, where the partnership is treated as a corporation for U.S. income tax purposes, a deemed disposition of the property (from the partnership to the corporation) may result and the preferential long-term U.S. capital gains rate on the deemed sale will not apply. Further, for Canadian tax purposes, kiddie tax may apply if rental income is allocated to minor children. If kiddie tax applies, the income allocated to the minor children will be taxed at the highest marginal tax rate on their Canadian tax return.

Canadian Trust

U.S. real estate may be exempt from U.S. estate tax if it is owned by a properly structured Canadian irrevocable inter-vivos trust. It can be particularly beneficial for a married couple to use a trust to purchase U.S. vacation property. Using this technique, one spouse creates the trust and funds it with the required amount of cash to purchase the property. The other spouse may be a trustee and beneficiary, along with children, if desired. However, the spouse who created and funded the trust cannot be a trustee of the trust nor have an interest in the property.

It is also possible to transfer ownership of U.S. real estate property already owned to a properly structured trust of this kind to eliminate your exposure to U.S. estate tax. However the transfer of ownership may trigger a disposition for Canadian tax purposes and may be considered to be a gift subject to U.S. gift tax. Therefore it is important to consider any U.S. gift tax and Canadian capital gain tax that may be triggered by the transfer. An alternative strategy when the property is already owned directly may be to use a U.S. revocable living trust, as discussed earlier in this article.

With the use of a trust it is possible to avoid some of the negative Canadian tax consequences associated with owning U.S. real property inside a Canadian corporation. However, all of the capital property in a Canadian trust is generally subject to a deemed

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disposition every 21 years of the trust's existence.

Where U.S. rental property is purchased by the trust negative income tax consequences may result. For example, U.S. rental income earned in the trust and allocated for taxation purposes to a beneficiary who is a spouse or minor child may trigger the Canadian income attribution rules or kiddie tax rules. For Canadian tax purposes, the attribution rules specify that the spouse who gifted the funds to the trust will be required to report the rental income on their personal Canadian income tax return, while the beneficiaries of the trust will report the rental income on their U.S. income tax returns. Since the spouse who gifted the funds cannot claim a foreign tax credit on their Canadian income tax return for the U.S. income tax reported by the beneficiaries, double taxation occurs.

Speak to your cross-border tax advisor for more information regarding the use of trusts to purchase U.S. real estate.

Evaluate the Options

There are many factors (such as Canadian and U.S. income tax implications and U.S. gift andt estate tax exposure) that must be considered when determining the most appropriate ownership structure for you. You should also consider your long-term intentions for the property, giving thought to how long you wish to own the property, whether the property will be used to earn income and whether you want the property to be maintained for the benefit of future generations of your family.

There is no single approach that is right in all circumstances, and as with many complex decisions, there will be trade-offs. For example, you may not wish to deal with the administration required by some of the more complex strategies to reduce or minimize your U.S. estate tax exposure. In any case, it is very important to consult with a professional cross-border tax or legal advisor who can help you review your specific situation to determine an appropriate approach that you are comfortable with.

Please contact us for more information about the topics discussed in this article.

U.S. Real Estate Property Ownership Options for Canadians

This table provides a list (not an exhaustive list) of common ownership options for Canadians purchasing U.S. real estate. It is provided for informational purposes only. Consult with a professional tax or legal advisor before implementing any of these options to ensure your own personal circumstances are considered.

Common Ownership Structures	Potentially Eliminates U.S. Estate Tax Exposure?	Complexity	Items to Consider
Sole Ownership[1]	no	low	U.S. state probate tax and guardianship issues in cases of incapacity.
Tenants in Common[1]	may minimize	low	U.S. state probate tax and guardianship issues in cases of incapacity. Divided interest can be sold or bequeathed to anyone and may affect market valuation. Double taxation if Canadian attribution rules apply.
JTWROS	no	low	Avoids U.S. state probate tax on first death but property may be subject to U.S. estate tax twice in a generation. Double taxation if Canadian attribution rules apply.
U.S. Revocable Trust[1]	no	high	Divided interest can be sold or bequeathed to anyone.
Canadian Corporation	yes[2]	high	Higher cost to set up; higher tax rate in U.S. on sale; personal use of property may be considered a taxable shareholder benefit from a Canadian income tax perspective. Double taxation if U.S. rental property is held in a corporation.
Canadian Irrevocable Trust	yes[2]	high	Settlor loses control of the property; 21-year deemed disposition rule applies. Double taxation possible if U.S. rental property is held in a trust.
Canadian Partnership	yes[2]	highest	Look through if no business purpose. Higher tax rates in U.S. on the sale of property if treated as corporation using "check the box" strategy.

1) Consider non-recourse mortgage or purchase of life insurance through an Irrevocable Life Insurance Trust (ILIT) to manage U.S. estate tax exposure.

2) If structured properly

Note: Vacationing in the U.S. in a property you are renting does not involve ownership, therefore, no further exposure to U.S. estate tax is created. Renting instead of owning can provide a greater opportunity for exploring different locations in the U.S. and may even help in determining preferable locations to vacation or to make an investment.

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