By Randy Perram

California Dreamin':

What you need to know before buying Real Estate in the United States

"All the leaves are brown
and the sky is grey
I've been for a walk
on a winter's day

I'd be safe and warm
if I was in L.A.
California dreamin'
California dreamin'
on such a winter's day"

The Mamas and the Papas

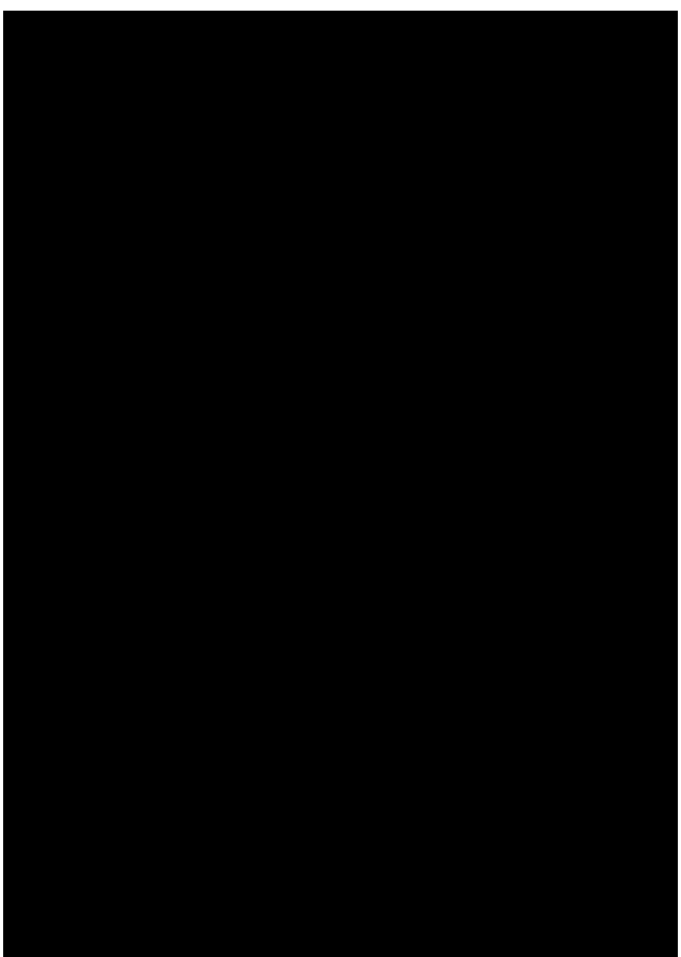
I consider myself very lucky to live in such a beautiful and majestic country as Canada. From the Maritimes to the Prairies and the Rocky Mountains, there really is no place like it. Canadian summers are legendary; we all enjoy our BBQ's, cottages and festivals. A summer in Canada is on par with any place in the world. If there is any criticism it's that our summers are too short – ask any Canadian. In fact, we are obsessed with weather and small-talk about the weather is part of our Canadian DNA.

The reality is we are a winter country, and it's always a little depressing when the first leaf turns and thoughts of the long winter ahead start to percolate. For some, it's off to the travel agent to book that holiday in Mexico or Las Vegas. For others, preparations are made to buy the winter dream home in the USA Sun Belt.

Buying real estate in the United States can be tricky, and a little research will go a long way to make the experience enjoyable and stress-free. Our cultures have blended so much that we often forget we are two separate countries with very different and distinct foreign ownership laws and customs.

One of the first and most important decisions is location. Where will you buy that dream condo or house? Have you spent any time there? Have you looked at neighborhoods? What amenities are available? How close is the nearest hospital, grocery store or airport? What about the environment, safety, etc.? Many experts suggest renting for a year to determine whether the residence fits your lifestyle and meets your expectations. Often, decisions are made based on a previous vacation, friends, or (worse yet) a brochure. Be honest with yourself and imagine spending up to six months a year in that location.

Once you've decided on a locality the next question is – what type of property do I want? Are you looking for a condo, a single-family house or maybe a mobile home in an upscale retirement park? All of these properties will require ongoing expenses such as condo fees, utilities, property taxes, maintenance, lawn care, insurance, etc. These fees and expenses will obviously be in US dollars, and to fund these costs using Canadian dollars could be an added expense. To reduce currency risk, you should create a budget outlining your monthly expenses. Once you have a rough idea of your annual costs, you can re-allocate a portion of your financial portfolio to invest in US dollar-denominated securities. When the Canadian dollar is high relative to the US dollar, converting Canadian dollars may make sense. When the Canadian dollar is low relative to the US dollar you can fund these expenses with US dollars thus lowering your overall exposure to currency risk.



After deciding where you want to buy and the type of property you want, it's time to consider title and possibly a mortgage. One tax trap many couples fall into is buying the property in one name. In Canada, adding or removing a spouse's name from the property title is relatively easy but in the US it will trigger a gift tax. The tax can range from 18% to as high as 48%. This is an example of how a small oversight can lead to serious problems when selling or when the owner dies.

The type of mortgage used to finance the property can have a substantial effect on US estate taxes due upon the owner's death. If a standard mortgage was held on US real property at the time of death, then a fraction of the mortgage balance, equal to the ratio of US situs (or located) assets to worldwide assets, can be used to reduce the taxable US estate. However, if non-recourse financing (i.e., a mortgage that is collectable only against a specific property and not against any other assets of the individual) is used for real estate, the taxable value of the US estate is reduced by the full balance of the non-recourse financing.

If a US property is refinanced using a non-recourse mortgage, then not only can US estate tax be minimized, but if the loan monies were used to purchase investments (stocks, bonds, mutual funds, etc.), then the interest on the non-recourse mortgage can potentially be tax-deductible for Canadian tax purposes. These mortgages can be acquired through the US division of most large Canadian banks such as RBC Centura.

The United States has the world's largest equity market. As a result, many individuals currently are invested directly in shares of US corporations. Some individuals have also purchased US real estate for a vacation home or for a source of income as a rental property. At the time of purchase, many high net-worth individuals are unaware of the onerous tax the US government could levy on these investments upon that person's death.

United States estate tax is based on the fair market value of the assets of the estate located or deemed to be located within the US upon death. This is much different from Canadian "deemed disposition" tax upon death where tax is only payable on capital gains accrued at death on capital property (i.e. stocks, bonds, mutual funds, real estate, etc.). For this reason, even if a US-based asset has lost value since you acquired it, you may still be exposed to US estate tax on the full-valued asset!

For the year 2007, Canadians should keep these two thresholds (all in US dollars) in mind:

1. $60,000: If an individual's US situs (located) assets are $60,000 US or less on death then there would be no US estate tax payable regardless of the value of their worldwide assets.
2. $2,000,000 worldwide estate:
    a. If an individual's worldwide estate is $2 million US or less upon death, then there would be no US estate tax payable.

b. If an individual's worldwide estate is greater than $2 million US upon death, then there could be US estate tax on the value of all US situs (located) assets. US estate tax can range from 18% to 45% of taxable amount.

STRATEGIES TO MINIMIZE US ESTATE TAX

If an individual has determined they currently have a US estate tax liability based on the thresholds above, then there are various strategies that can be considered to reduce their exposure to US estate tax. The strategies outlined below are general in nature and specific circumstances will determine the benefit of one strategy over another. These strategies are of course not an exhaustive list of all the techniques to minimize US estate tax; however, the more common strategies are noted.

GIFT US SITUS ASSETS PRIOR TO DEATH

Gifting of real estate and other tangible personal property (i.e. automobiles, art, jewelry, etc.) located in the US can trigger US gift tax for US nonresident aliens, if the value of the gift exceeds certain minimum amounts. If the total value of all gifts to any individual is $12,000 US or less (2007 value) in a given year, these gifts do not attract gift tax. This threshold rises to $125,000 US (2007 value) if the gift of tangible property is made to a spouse who is not a US citizen. This exemption may allow for the "re-balancing" of US situs assets between spouses in order to minimize US estate taxes. Note that using the exemption may minimize or eliminate US gift taxes, and any Canadian taxes on capital gains would be deferred because of the ability to transfer assets to a spouse with no immediate tax implications. However, the Canadian spousal attribution rules would still apply on any investment income generated on the assets gifted to a spouse.

LIFE INSURANCE

Some Canadian residents use life insurance to pay for any capital gains tax arising on their death due to our deemed disposition rules. Similarly, one of the simplest methods to pay for potential US estate tax is to maintain sufficient life insurance to cover this liability on death. However, this may be expensive depending on the age and health of the property holder.

Furthermore, although life insurance may be used to pay for one's US estate tax liability, ironically for purposes of the US estate tax thresholds and calculations, life insurance proceeds will generally form part of the deceased's worldwide estate if the deceased had incidents of ownership. This rule will serve to potentially increase the US estate tax payable since the Unified Credit (explained further on) that can be claimed will be lower. Furthermore, the life insurance proceeds may push your worldwide estate over the $2 million US exemption, thus creating potential US estate tax now on your US situs assets. However, it may be possible to exclude the life insurance proceeds from the worldwide estate calculation by having the policy held in a special irrevocable life insurance trust.

SELL US SITUS ASSETS PRIOR TO DEATH

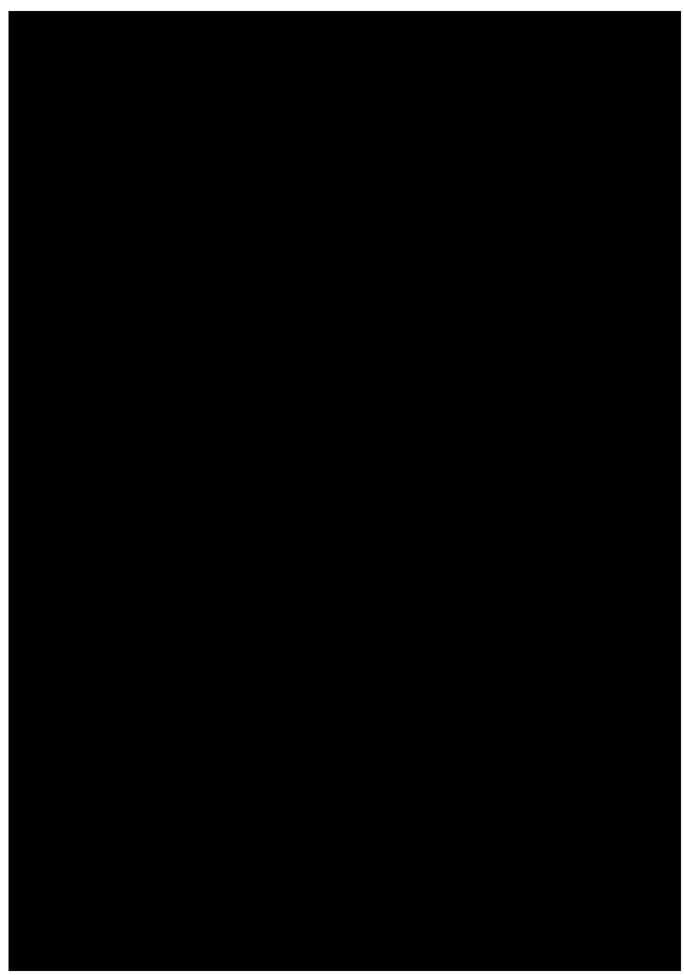
This is the easiest and least complicated of solutions; however, it is generally applicable only when the owner becomes seriously ill or just before anticipated death. The reason why this strategy may not be appropriate is the sale of assets can trigger a premature tax liability in Canada on the realized capital gain.

JTWROS OWNERSHIP OF PROPERTY

Holding property in Joint Tenancy with Right of Survivorship (JTWROS) with your spouse or another person may result in only a proportionate share of the total value of the property to be part of the deceased's estate for US estate tax purposes. However, in order for this strategy to work, it is important to be able to demonstrate the surviving tenant(s) contributed to the purchase of the assets within the JTWROS account with their own funds.

HOLD US SITUS ASSETS IN A CANADIAN HOLDING COMPANY

Just as shares of US companies are defined to be US situs property, shares of non-US companies are defined not to be such property. Accordingly, the shares you hold in a bona fide Canadian corporation are generally not subject to US estate tax. This means that you



may use a Canadian company to hold your US assets to insulate you from US estate taxes. However, for this strategy to work the corporation must be legal and created under relevant corporate laws.

Unfortunately, there is a cost to this. Using a company does involve additional tax filings and financial reporting expenses as well as possible corporate capital tax liabilities. In general terms, this is a very risky strategy because you may be challenged by both the Canada Revenue Agency (CRA) and the US Internal Revenue Service (IRS) for tax purposes. The CRA may assert the provision of such personal assets by the corporation represents a taxable benefit to you.

HOLD US SITUS ASSETS IN A CANADIAN PARTNERSHIP

Although this strategy is complex, there are some experts that suggest holding US situs assets in a Canadian partnership with a family member. In this case, it may be possible to elect to treat the Canadian partnership as a Canadian corporation for US tax purposes, thereby potentially avoiding US estate tax as mentioned above. However, since the structure would be viewed as a partnership for Canadian tax purposes some of the negative Canadian tax consequences associated with owning US property inside a Canadian corporation may be avoided.

Due to the complexity with this strategy it is imperative that individuals consult with a qualified tax advisor for more details.

HOLD US SITUS ASSETS IN A CANADIAN TRUST

Again, this is a complex strategy; however, there are some experts that suggest a properly structured Canadian inter-vivos trust that purchases US situs assets including US real estate would not result in US estate tax for the beneficiaries for the US situs assets held in the trust. The settlor would fund the trust with cash, which the trust would then use to purchase US real estate (for example). To be safe, some US tax experts recommend the settlor should not be a beneficiary, and neither the settlor nor the beneficiaries should be trustees. Since the structure would be viewed as a trust for Canadian tax purposes, some of the negative Canadian tax consequences associated with owning US property inside a Canadian corporation may be avoided.

Due to the complexity associated with this strategy it is imperative that individuals consult with a qualified tax advisor for more details.

CHARITABLE DONATIONS

When US situs property, on which estate tax would otherwise be payable, is given or bequeathed to a charitable organization (Canadian- or US-based), operated exclusively for religious, charitable, scientific, literary or educational purposes, the bequest can be used to reduce the amount of US situs property on which US estate taxes are calculated. However, the deceased's will must contain specific provisions for the donation of these US situs assets.

REMEMBER YOUR NON-RESIDENT STATUS

Homeland security has ruled Canadian "Snowbirds" can visit the United States for six months less a day in any 12-month period. For example if you entered on June 15, 2007 your admission would be granted until December 14, 2007. For more information on this and other "Snowbird" questions log on to www.snowbirds.org.

CONSULT WITH YOUR FINANCIAL ADVISOR

These are some ideas and strategies that can help in planning the purchase of your dream property. This is by no means a comprehensive list, and the information is general in nature. I recommend you consult with your financial advisor or accountant for a more comprehensive analysis of your own particular situation. ■

SOURCE: US Estate Tax by Jeff Greenberg & Prashant Patel March 2007