

BY



GENA KATZ, FCA, CFP,
*an executive director
 with Ernst & Young's National
 Tax Practice in Toronto.
 "Tax Break" appears monthly.*

SOUTHERN EXPOSURE

Align with tax experts before advising clients on complex U.S. ownership structures.

The temperature has dropped, the Canadian dollar is soaring, and U.S. housing prices are falling. It appears the planets have aligned to make this a perfect time to buy that southern U.S. vacation home. There's still one small drawback, though—U.S. estate tax. However, with some careful planning, you can help your clients manage that cost.

So who has to pay U.S. estate tax? Under U.S. tax law, individuals (no matter their country of residence), who on death own significant U.S. situs property, including real estate and personal property situated in the U.S., or shares of U.S. corporations and debt obligations issued by U.S. residents, may be liable for U.S. estate tax. The rate of U.S. estate tax ranges between 18% and 45% depending on the value of the U.S. estate. By 2011, the maximum rate will increase to 55%.

Credit Check

The U.S. provides a unified credit against estate tax, effectively exempting the first \$2 million of estate value from tax. Yet, for individuals who are neither U.S. citizens nor U.S. tax residents, this exemption must be prorated based on the proportion of the value of U.S. total assets in the estate. If, for example, an individual's U.S. assets only represent 10% of the value of his \$10 million estate, the exemption will only be \$200,000 U.S. This credit will increase to \$3.5 million in

2009 and will be repealed for 2010. In 2011, it will be reinstated with an exemption of only \$1 million.

A further credit is allowed against the estate tax where the property is left to the Canadian individual's spouse or a spousal trust. And finally, Canada allows a foreign tax credit in respect of any U.S. estate tax payable, but limited to Canadian income tax payable in the year of death, related to the deemed disposition of the U.S. property. Where the value of the property is large, relative to the accrued gain, this tax credit will only provide a small amount of relief.

One strategy to consider is to reduce the value of the property that would be subject to U.S. estate tax by financing its purchase with an arm's length, non-recourse mortgage. This is a mortgage where the lender's only claim would be against the specific property pledged as security.

Your clients could also consider purchasing adequate life insurance to fund the U.S. estate tax liability on death. However, this may not be practical, or possible, for elderly individuals or those with serious medical conditions.

Complex Structuring

You'll recall that single purpose Canadian corporations were once commonly used to acquire U.S. vacation property. Since it was the corporation that owned the U.S. real estate,

there was no concern about estate tax on the death of the shareholder. Additionally, the CRA did not assess a taxable benefit to the shareholder for the personal use of the vacation property.

But the CRA changed its position on the taxable benefit issue and, as a result, single purpose corporations are not practical for U.S. properties purchased after 2004. However, the same results could potentially be achieved by using a Canadian partnership to purchase the U.S. property. To protect against U.S. estate tax, the partnership could elect to be treated as a corporation for U.S. estate tax purposes (referred to as a "check-the-box" election) and as a partnership for Canadian tax purposes. There would be no shareholder benefit issue.

Another structure that might be used to buy a U.S. vacation property is a Canadian personal trust, whereby the client settles the trust with sufficient funds to purchase the property, with the spouse and children being named beneficiaries. If the settlor is neither a trustee nor a beneficiary, the value trust property should not form part of his estate. Further, note that careful planning is required to work around the Canadian 21-year deemed disposition rule for trusts.

And in all cases, before proceeding, a professional tax advisor should be consulted to ensure the most effective plan is used for a person's particular situation. **AE** **KATZ**