Estate Tax for Canadians with U.S. Vacation Properties

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If you are about to purchase a U.S. vacation property, you may be wondering about the best way to structure the ownership. Should you use a corporation or a trust? Or should the property simply be bought in personal name? What about U.S. estate tax?

The good news is that for the majority of Canadians seeking to buy non-commercial U.S. real estate for personal use, such as a Florida condo or an Arizona vacation home, often the best and most cost-effective solution is simply to buy it personally. The biggest concern with personal ownership, however, is the potential application of the U.S. estate tax if you die owning the U.S. property.

Canada, of course, does not have an estate tax. Instead, we tax only the unrealized appreciation of assets (other than your principal residence) upon death, as well as the fair market value of your RRSP/RRIF. But if you are a U.S. citizen living in Canada or a non-U.S. citizen who owns "U.S. situs property" upon death, you may be potentially caught by the U.S. estate tax.

Rates

If you are a U.S. citizen or dual Canadian/U.S. citizen living in Canada, the U.S. estate tax applies to the fair market value of your worldwide assets upon death. Rates start at 18 per cent and reach 40 per cent once assets total more than US$1 million. But if you are like most individuals, you will not need not worry about paying any U.S. estate tax since there is a generous exemption, which doubled when President Donald Trump signed into law the *Tax Cuts and Jobs Act*, which came into effect on January 1, 2018.

While President Trump's original plan called for a complete repeal of the estate tax, the final U.S. law stopped short of that. Instead, it doubled the federal estate (and gift) tax exemption, such that it increased from US$5.6 million to US$11.2 million for 2018 (to be indexed annually). Technically, the exemption is applied in the form of a "unified credit" against U.S. estate tax payable. For 2018, the credit is valued at US$4,425,800, which is equal to the U.S. estate tax payable on US$11.2 million of assets.

That means that if you are a U.S. (or dual) citizen, you would have to have a worldwide estate of more than US$11.2 million (or nearly $14 million Canadian dollars!) before being subject to U.S. estate tax on death.

If you are a non-U.S. citizen, the estate tax only applies if you die owning U.S. situs property. The most common examples of U.S. situs property are U.S. real estate, or direct ownership of shares of U.S. corporations, even if held at a Canadian brokerage and even owned inside registered accounts such as RRSPs, RRIFs and TFSAs.

Exemptions

If you are not a U.S. citizen, you are entitled to a US$60,000 exemption under the U.S. domestic tax code, or to the potentially more generous prorated exemption under the Canada-U.S. tax treaty. The exemption is prorated by dividing your U.S. situs property by the value of your worldwide estate.

Mathematically, this means if you were to die in 2018 and your worldwide estate does not exceed US$11.2 million, your estate will get a full exemption from U.S. estate tax regardless of the value of any U.S. situs assets. If you are a Canadian who dies owning U.S. situs property and have an estate larger than US$11.2 million, you may still have some exposure to U.S. estate tax.

PwC's bulletin, Estate tax update – US estate tax exposure for Canadians (2018 edition),[1] includes an example of a high net worth individual, David, who is a Canadian resident (not a U.S. citizen) and owns U.S. situs property upon death worth US$1.5 million. His entire estate is valued at US$15 million.

If David dies in 2018, he would only be subject to U.S. estate tax on the value of his U.S. condo, worth US$1.5 million. The estate tax on this amount, before deducting the unified credit, works out to US$545,800 by applying the graduated U.S. estate tax rates to the US$1.5 million condo value.

Under the Canada-U.S. treaty, David's estate can claim a pro-rated unified credit equal to US$442,580, which is calculated by pro-rating the full credit (US$4,425,800) by the ratio of his U.S. situs property (US$1.5 million) to his worldwide estate (US$15 million) or 10 per cent. Thus David's U.S. estate tax bill would be reduced to US$103,220 (US$545,800 – US$442,580).

If David was married at the time of his death, in addition to the unified credit, David's estate may also claim a marital credit under the tax treaty if the U.S. situs asset is left to his surviving spouse on death. The marital credit is equal to the lesser of the unified credit and the amount of the estate tax. The result is that if David were to leave his U.S. condo to his wife, who is also a Canadian resident (and not a U.S. citizen), his U.S. estate tax liability would be completely eliminated.

For high net worth Canadians, more complex planning is available. This typically involves the use of a Canadian discretionary trust to own the U.S. real estate or obtaining a non-recourse mortgage against the U.S. property.

But even if you're well below the 2018 exemption of US$11.2 million, you should be aware that the doubled exemption is only temporary and effective if you die between 2018 through 2025. After that time, unless permanent legislation is enacted, the exemption will return to the pre-2018 regime (US$5.6 million) in 2026.

And, of course, let's not forget that should the Democrats regain legislative power in the near future, President Trump's increased exemption could be even more short-lived. The 2016 Hilary Clinton Democratic tax plan had the estate tax exemption dropping to US$3.5 million with the top rate increasing to as high as 65 per cent for some estates.

You may want to keep this in mind if you plan on living a bit longer.

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[1] *Tax Insights: Estate tax update – US estate tax exposure for Canadians (2018 edition)* from PwC is available online at https://www.pwc.com/ca/en/services/tax/publications/tax-insights/estate-tax-update-us-tax-exposure-canadians.html.

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