moodys LLP tax advisors

Moodys LLP Tax Advisors
2910, 715 – 5 Avenue SW
Calgary, AB T2P 2X6
Main 403.693.5100
Fax 403.693.5101
www.moodystax.com

WAIT!

Consider the Tax Consequences Before You Purchase a Vacation Home in the US

Roy A. Berg, JD, LL.M (US Tax)

By now it is difficult to find a Canadian who has not heard of the buying opportunity in US vacation homes. The weakness of the US real estate market and the strength of the Loonie combine to make US vacation properties seem like a bargain to many Canadians. However, before you jump into the investment you should be aware of the tax consequences, because an unanticipated tax bite can quickly turn a sweet deal sour.

Before delving further into this topic, however, it is important to know that the following discussion makes several important assumptions:

- You are purchasing vacation property and not rental property;
- You are not a US citizen;
- You are not, and never have been, a US green card holder;
- You are not domiciled in the US;
- You do not spend more than 121 days per year in the US on average; and
- You do not spend more than 182 days per year in the US.

If any of the foregoing describes your situation, you may already have US tax issues and should seek experienced US tax counsel.

A. Calculating the US Estate Tax for Canadian Residents

If you own a US vacation home, you have US estate tax implications and your heirs may be required to pay US estate tax on the fair market value ("FMV") of that home at your death. However, because of the tax treaty between the two countries Canadian residents are subject to US estate tax only if the FMV of their worldwide assets (including life insurance proceeds) exceeds the US estate tax credit equivalent (the "Exemption"), and then only the value of their US property is taxed.

In 2012 the Exemption is $5,120,000 but will be reduced to $1,000,000 in 2013 unless the US Congress changes existing estate tax law. In the last six months both houses of the US Congress have proposed raising the Exemption up to now, none of the proposed legislation has been enacted into law. Both the Exemption and the applicable tax rates have varied greatly over the years and it is really anybody's guess as to what the Exemption and the applicable estate tax rates will be in 2013 and beyond. The following table illustrates the volatility in the Exemption and rates in the past decade.

Year	Max Rate	Exemption
2000	55%	$675,000
2003	49%	$1,000,000
2005	47%	$1,500,000
2007	45%	$2,000,000
2009	45%	$3,500,000
2010	No tax	Unlimited
2011 - 2012	35%	$5M
*2013	55%	$1M

The full Exemption is available only to US citizens. As a Canadian resident the treaty allows you only a portion of the Exemption. The portion is determined by dividing date of death value of your US property by the date of death value of your worldwide assets (calculated using US tax principles not Canadian tax principles):

Exemption x (Value US Property ÷ Value Worldwide Assets)

Therefore, if the value of your US property is $1,000,000 and the value of your worldwide assets is $8,000,000 then you will be subject to US estate tax on the difference between $1,000,000 and $625,000 [$5,000,000 x ($1,000,000 ÷ $8,000,000)], or $375,000.

It is important to remember that the US estate tax applies to both US real estate and other US property, including US stocks and bonds. Therefore, owning US stocks and bonds exposes you to the exact same US estate tax liability as owning US real estate. This discussion, however, addresses the US estate tax only with respect to US real estate. There are strategies to minimize the estate tax applicable to these investments similar to those set forth below.

B. CANADIAN TAX CONSEQUENCES TO OWNING US VACATION PROPERTY AT DEATH

If, when you die, you own US vacation property your heirs will have both US estate tax issues and Canadian income tax issues. Canada will tax the gain inherent in the US real estate at the date of death with an exception for property passing to a surviving spouse. However, depending on how the property is owned, Canada may provide a partial credit against these taxes with the estate taxes owed to the US.

Frequently, the taxes owed to Canada will be lower than the US estate tax and therefore the application of the foreign tax credit may result in few additional taxes owed in Canada. The application of the law in this area is very complex and can produce counterintuitive results. However, in general the Canadian taxes are typically at lower rates than the US estate tax and Canada taxes only the gain in the property (and not on the gross value of the property, as with the US estate tax). Consequentially the estate will frequently pay tax only at the US estate tax rates.

Nonetheless, the provinces generally do not allow the US estate taxes to offset provincial taxes therefore the estate may be subject to double tax to some degree.

C. DO NOT OWN US VACATION PROPERTY IN A LIMITED LIABILITY COMPANY (“LLC”) OR REVOCABLE LIVING TRUST

In the US, LLCs and revocable living trusts are very frequently used as a vehicle to own real estate, and for US citizens who are not Canadian residents there can be great benefits to using these. Since these vehicles are so common in the US it is not unusual for US advisors to innocently recommend them to Canadian residents. However, the Canadian income tax consequences to using these vehicles can be disastrous for the following reasons:

- Both LLCs and revocable living trusts do nothing to avoid the US estate tax.
- LLCs are taxed as partnerships in the US but they are taxed as corporations in Canada. Use of an LLC can, therefore, result in double taxation, lack of treaty protection, and recognition of “taxable benefits,” as discussed below.
- Revocable living trusts are ignored for US income tax purposes, but this is frequently not the case for Canadian purposes. Use of a revocable living trust may, therefore, result in double taxation.

D. OPTIONS FOR OWNING US VACATION PROPERTY

There are many options to hold US vacation property that effectively minimize both the US estate tax and Canadian income tax. The first step, however, is to determine whether you will have an estate tax liability and, if so, the extent of that liability. The second step is to determine which of the following options has the lowest cost of implementation and operation in light of the tax savings. There is no "one size fits all solution" as everyone has different facts, goals, objectives, and risk tolerance.

1. Cross-Border US Real Estate Trust

Assuming the US estate tax exposure warrants, a very effective option for holding US vacation property is through a cross-border US real estate trust. If the trust is properly drafted, executed, and administered this option will remove the value of the vacation property from your US taxable estate and will not result in adverse US or Canadian income tax consequences. The primary drawbacks are that the settlor of the trust must relinquish control and, pursuant to Canadian law, the trust is deemed to have disposed of its property every 21 years from the original creation date.

To establish the trust, the settlor contributes money (and NOT a promissory note) to the trust, the trustee of which is the settlor's spouse and the beneficiaries of which are the spouse and the children. The amount contributed must be sufficient to purchase the real estate. The trustee (spouse) then purchases the vacation property in the name of the trust. The settlor may make additional contributions to the trust in order to pay the ongoing expenses of the residence but, otherwise, must have no further involvement with the trust.

It is important that the settlor is neither trustee nor beneficiary of the trust or else the entire value of the trust will be included in the settlor's estate upon his death. Since the trust will own vacation property it will not generate income and therefore there will be no US or Canadian income tax filing requirements.

As mentioned above, Canadian trusts are deemed to dispose of their assets on the 21st anniversary of their settlement. Therefore, the trust must be drafted with this limitation in mind.

While cross-border trusts are a very effective vehicle for holding US vacation property, the typical Canadian discretionary trust (or "cottage trust") will not effectuate the objectives discussed above unless modified to address US tax issues. Likewise, any of the following errors will cause the trust to be ineffective for US estate and income tax, or Canadian income tax purposes:

- *Drafting errors* – the trust must be drafted correctly;
- *Funding errors* - the settlor should not fund the trust with a promissory note;
- *Titling errors* – legal title to the property must be in the name of the trustee acting on behalf of the trust; or
- *Errors in the operation of the trust* – the trust's legal existence must be respected.

2. Personal Ownership

In many cases it may make sense to acquire the vacation property personally if the US estate tax consequences are minimal under the treaty. If you are married you can maximize the available Exemption by taking title of the property in the name of the spouse who has lower net worth. If the spouse taking title to the property owns nothing other than the US vacation property (an unlikely yet plausible scenario) he or she will enjoy the full Exemption otherwise available only to US citizens.

For example, using the formula set forth above, if the spouse owns US property worth $1,000,000 and no other property, he or she will be entitled to use the full Exemption:

$1,000,000 ÷ $1,000,000 = 100 percent

It is important to note that the Canadian attribution rules may affect the results for Canadian income tax purposes, so you need to obtain the advice of experienced tax counsel before undertaking this ownership strategy (see paragraph 6, below).

3. Joint Tenancy With Right of Survivorship

It is very common in the US and in Canada for spouses to own property as joint tenants with right of survivorship. This type of ownership provides that when the first joint tenant dies the survivor automatically succeeds to the entire value of the property. While this form of ownership is beneficial in that it avoids probate in the state in which the property is located, it may have adverse US gift and estate tax consequences.

First, if one spouse does not contribute his or her own funds to acquire the property, the US gift tax may apply upon acquisition.

Second, for US estate tax purposes the spouse who dies first is presumed to have contributed 100 percent of the capital necessary to acquire the property, consequentially the entire value of the property will be included in that spouse's estate at his or her death. The executor can rebut this presumption only if it has evidence to show that the property was not so acquired. When the surviving spouse dies the entire value of the property will also be included in his or her US estate. The result could be a doubling of the US estate tax.

For these reasons it is generally not recommended that Canadians take title to US property as joint tenants with right of survivorship.

4. Tenancy in Common

Instead of taking title to property as joint tenants with right of survivorship you can take title to US real estate as tenants in common. The basic difference in the two methods of holding title is that a tenant in common does not automatically inherit the interest of the other tenant in common. While this form of ownership will subject the estate to probate in order to transfer title, it can have beneficial US estate tax consequences.

Since title of the property does not automatically pass to the surviving spouse at the first death, there is no presumption that the deceased spouse furnished 100 percent of the consideration to acquire the property. As a result, only the decedent's percentage interest in the property will be included in his estate at death. Further, based on US valuation principles the decedent may be entitled to a discount on the aliquot portion of his ownership interest.

For example, if husband and wife own the property equally as tenants in common and husband dies, the value of the property included in his estate for US estate purposes may be less than 50 percent. Frequently, the IRS will allow a 15 percent discount on the interests of the tenants in common because of the difficulty of selling only a partial interest in the property.

For these reasons, if you wish to own US vacation property individually, it is preferable to hold the property as tenants in common instead of as in joint tenants with a right of survivorship. Further, if you already own US vacation property as joint tenants with right of survivorship, you can potentially save

significant US estate tax by simply changing title to tenants in common.

5. Non-Recourse Mortgage

If you already own the US vacation property, non-recourse financing can be a very effective method to reduce your US estate tax exposure. A non-recourse mortgage is an arms-length loan that is collectible only against the particular property and not against the assets of the borrower. In determining the value of the US property included in an individual's estate the IRS allows a deduction for a non-recourse mortgage encumbering the property provided the mortgage is recorded and is reflected on the title of the property.

Given the weakness of the US real estate market it can be difficult to obtain non-recourse financing from an arms-length lender, and the financing that is available typically has an interest rate that is substantially higher than traditional financing.

6. Ownership In Canadian Corporation

If you were concerned only with exposure to US estate tax you could own the US vacation property in a Canadian corporation. While effective in avoiding US estate taxes, this option can have very adverse Canadian income tax consequences. Under general Canadian principles of taxation, property owned by a corporation that is used by the shareholders of that corporation (as would be the case with US vacation property) triggers a "taxable benefit" to those shareholders, which is included in the income of those shareholders.

In many cases the imputed income resulting from the Canadian "taxable benefit" can easily outweigh the US estate tax savings and is generally not an economically viable option to holding US real property.

7. Canadian Partnership

It is extremely risky to purchase US vacation property in a Canadian partnership because, at this time, it is unclear whether the partnership interest will be subject to US estate tax. The IRS may deem the partnership's trade or business to be located in Canada (which is good) or in the US (which is bad). Until this uncertainty is resolved prudence would dictate avoidance of this option to holding US vacation property.

US tax law permits certain business entities, including partnerships, to elect to be taxed as corporations. This election is commonly known as a "check the box" election and the resulting entity is taxed as a partnership for Canadian purposes but as a corporation for US purposes, these entities are commonly known as "reverse hybrids." The result is that the deceased shareholder (who is a partner for Canadian purposes) would be considered to own shares in a Canadian corporation at death (see above) rather than US real estate. This is a very risky strategy because the election must be made at a time when the family likely has non-tax issues in mind and the failure to do so may subject the decedent to US estate tax.

8. Life Insurance

Once the exposure to the US estate tax has been determined, a very cost effective solution may be to use a life insurance plan to pay the ultimate tax liability. Of course the cost effectiveness of this solution depends on the cost of the premiums, which will depend on the age and health of the insured life or lives.

It is important to remember that insurance proceeds on a non-US citizen who is not a US resident are not considered "US property" subject to US estate tax. However, the proceeds are considered part of the individual's worldwide assets at death. As a result the Exemption available to the decedent will be

reduced because the denominator of the fraction used to determine the Exemption (see the formula above) will increase and therefore reduce the available Exemption.

E. COLLECTING RENT ON YOUR US VACATION PROPERTY

After the shine of owing US vacation property has worn off many Canadians seek to defray the costs of property ownership by renting the property. This will likely happen to you so there are a few things you should know when you reach this stage.

Generally, non-US citizens who are not resident in the US are not required to file US tax returns to report this rental income. However, under US law the gross rents are subject to a flat 30 percent withholding, which the tenant or a property management company is required to withhold and remit to the IRS.

While a 30 percent withholding of gross rents can cause serious timing and cash-flow complications, you can take steps to mitigate these consequences by providing the tenant or management company with the form W-8ECI and making an election on your annual 1040NR.

The rules in the US are generally more restrictive than the rules in Canada regarding claiming expenses against rental income. In particular, the property must be rented for a minimum of 15 days to claim expenses. Further, there are restrictions against using losses generated by this activity that may be carried forward to future reporting periods.

For example, if you own the property personally and you end up with positive net rental income, you will pay US tax on that income and you will be entitled to claim a foreign tax credit on your Canadian income taxes to the extent of the US income taxes paid. However, you will not be able to obtain a refund for Canadian purposes of the excess paid.

F. FOREIGN TAX CREDIT ISSUES AND CANADIAN ATTRIBUTION RULES

Under Canadian law, property gifted from one spouse to another can cause the gain on the sale of that property to be attributed back to the "gifting" spouse. Therefore, if you've purchased US vacation property as joint tenants and one spouse provided all of the funds, the gain on the sale of the property can attributed to the spouse who furnished the funds. This could cause a mismatch of the foreign tax credit, which results in double tax.

For example, assume a husband contributes 100 percent of the funds to acquire the property and that both husband and wife take title to the property as joint tenants. When the property is sold the US will attribute 50 percent of the gain to the husband and 50 percent of the gain to the wife (the US does not have a spousal attribution rule). For Canadian purposes, the results may be quite different. CRA could argue that since the husband has contributed 100 percent of the funds to purchase the property he should be taxed on 100 percent of the gain. If this is the result, the US tax paid by the wife could be forever lost for Canadian tax purposes.

In this situation, it is possible to avoid the foreign tax credit mismatch with some planning before sale. To remedy the situation the non-contributing spouse (the wife in the above example) would execute a quit-claim deed, which transfers the interest to the contributing spouse (the husband). By taking these steps prior to sale, the contributing spouse (the husband) will be liable for 100 percent of the US and Canadian tax on the gain and there will be a synchronization of the foreign tax credit, resulting in a single level of tax.

G. SALE OF US VACATION HOME

If you own US vacation property there will likely come a time when you wish to sell it. On that day there will be US and Canadian tax issues of which you should be aware.

1. US Income Tax Consequences

Upon the disposition of the property you will be required to report the sale on the US form 1040NR and pay the resulting US tax. In 2012 long-term capital gains are taxed at a top marginal rate of 15 percent. In 2013 this rate is scheduled to increase to 20 percent unless the US Congress steps in and changes the law. In addition, if the property is located in one of the 47 states that impose an income tax you will be required to pay state income tax on the gain as well.

In addition to the income tax the Foreign Investment in Real Property Tax Act (FIRPTA) requires the buyer to withhold a portion of the gross proceeds whenever a non-US citizen sells US real property. For Canadian residents this withholding is generally 10 percent of the gross sales price, regardless of whether the property is sold at a gain or a loss. After closing you can obtain a refund of this withheld amount if your capital gain tax liability is less than the amount withheld.

2. CANADIAN INCOME TAX CONSIDERATIONS

In determining the gain or loss that must be reported for Canadian tax purposes you must take into consideration currency exchange rates on the date the property was acquired and then again on the date of sale. Thus, even though you may have a notional gain or loss on the sale of the property, the actual gain or loss that is reported for Canadian tax purposes may be much different.

Because the Canadian dollar is much stronger now than it was just a few years ago, there is a possibility that the gain for determining Canadian taxes will be much less than the US gain. A Canadian loss could even result, (which is not deductible for Canadian purposes). Consequentially, the full amount of taxes paid to the US may not be fully creditable against your Canadian tax liability.

H. CONCLUSION

The US vacation property market is currently very attractive to Canadians and it is frightfully easy to transition from "shopper" to "owner" before you even know what happened. This is not necessarily a bad thing because, after all, a good deal is a good deal. However, before you find yourself caught in the buying frenzy there are both US and Canadian tax issues you need to consider before signing on the dotted line. There are numerous pit falls and traps for the unwary, which can be avoided (or at least minimized) with a little tax planning ahead of time.

This article does not constitute legal, accounting, or other professional advice. It is intended as a general discussion of the issues presented and neither a definitive analysis of the law nor a substitute for professional advice.

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