

The Navigator

RBC WEALTH MANAGEMENT SERVICES

Canadians Acquiring U.S. Real Estate – U.S. Estate Tax

Strategies to minimize or potentially eliminate your exposure to U.S. estate tax

In a struggling U.S. economy with depressed real estate prices and the strong Canadian dollar, many Canadians are considering owning real estate in the U.S. for investment purposes or as vacation properties to escape the Canadian winters.

While it is important to understand both the Canadian and U.S. income tax considerations of owning or renting property in the U.S., (which is the topic of a separate article) the potential exposure to the U.S. estate tax regime often leads Canadians to question how they should own the U.S. property.

If you own U.S. real estate property at the time of your death, your estate could be subject to U.S. estate taxes. Depending on the value of your U.S. property, this could be a substantial liability for your estate. For deaths in 2012, U.S. estate tax (with a maximum tax rate of 35%) applies when the value of a Canadian's worldwide estate exceeds US\$5.12 million, and their U.S. situs property

(including U.S. real estate) is valued at more than US\$60,000. Unless further legislation is enacted by the end of 2012, the maximum U.S. estate tax rate will increase to 55% and the value of your worldwide estate need only exceed US\$1 million to expose you to U.S. estate tax. A detailed discussion of U.S. estate tax for Canadians is available in a separate article. Ask your RBC advisor for a copy.

In this article, we focus our discussion on common ownership strategies and how they may help you minimize or potentially eliminate exposure to U.S. estate tax. The most common types of ownership are:

- › Renting
- › Sole Owner

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

Refer to the table at the end of this article for a summary of the common ownership strategies discussed in the following sections.

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



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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.

Renting

Canadians who rent instead of purchasing a property in the U.S. will not create or increase their exposure to U.S. estate tax. Renting a property allows you to visit different locations in the U.S. Renting may also enable you to explore a location to determine if it is the right place to vacation or to make an investment in real estate.

Sole Owner

If you prefer to own rather than rent, direct ownership may be the simplest and least costly structure to implement.

A Canadian who dies in 2012 owning U.S. real estate and other U.S. situs assets that are valued below the two thresholds discussed earlier (US\$60,000 of U.S. situs assets and US\$5.12 million of worldwide assets) will not be exposed to U.S. estate tax. However, after 2012 if your worldwide estate is greater than US\$1 million at the time of your death you may be exposed to U.S. estate tax.

If the value of your U.S. real estate or other U.S. situs assets is above the thresholds but you intend to transfer the property to your spouse or a properly structured spousal trust upon your death, you may still be able to own your property directly if your exposure to U.S. estate tax will be eliminated by claiming a marital credit. Ask your cross-border tax advisor to confirm (if direct ownership of the property is desired) that you can eliminate your exposure to U.S. estate tax by claiming the marital credit. A more detailed discussion of U.S. estate tax and the marital credit is provided in a separate article on U.S. estate tax for Canadians. Ask your RBC advisor for a copy.

Non-recourse mortgage

If the value of your U.S. real estate or other U.S. situs assets is above the thresholds and the marital credit will not eliminate your exposure to U.S. estate tax, you may still be able to own your property directly and avoid or minimize U.S. estate tax by implementing a non-recourse mortgage.

The U.S. estate tax rules allow you to deduct debts and certain expenses in determining your U.S. estate tax liability. For example, funeral costs and certain administrative expenses are fully deductible. However,

Canadians who rent instead of purchasing a property in the U.S. will not create or increase their exposure to U.S. estate tax.

the amount that a Canadian can deduct for certain debts and expenses may need to be prorated based on the ratio of your U.S. situs assets to your worldwide assets. For example, you cannot deduct the full value of a regular mortgage on U.S. real estate property, but you can deduct a prorated value. However, with a non-recourse mortgage, which is collectable only against the property itself and not against any other assets of the individual, you are permitted to deduct the full balance of the non-recourse mortgage against the value of the U.S. situs assets. This may reduce or eliminate your exposure to U.S. estate tax.

Note: If the property increases in value, you may only deduct the amount of the non-recourse mortgage. Therefore, a portion only of the value of the property could be included as a US situs asset unless you refinance the non-recourse mortgage.

For Canadian tax purposes, if you use a non-recourse mortgage to refinance your U.S. real estate, you may also be able to deduct the interest you pay on your Canadian tax return if the borrowed funds are used to purchase investments (stocks, bonds, mutual funds, etc.).

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

Joint Tenancy With Rights of Survivorship (JTWROS)

It is not generally recommended that Canadians own U.S. real estate as JTWROS. This is due to the possibility that U.S. estate tax may be payable on the death of each joint tenant. For example, if a married Canadian couple each contributes 50% to the purchase of a property in Arizona, half the fair market value of the property will be subject to U.S. estate tax when the first spouse dies. The deceased spouse's half interest in the property will automatically be transferred to the surviving spouse. When the surviving spouse dies, the full value of the property will be included in determining the U.S. estate tax. Consequently, the property may be subject to U.S. estate tax twice in the same generation. There is a credit that may reduce the U.S. estate tax of the surviving spouse if he/she dies within 10 years; however, this credit is significantly reduced on a sliding scale after 2 years.

If you hold U.S. property as JTWROS, you may wish to consider severing the joint tenancy based on each tenant's contributions and holding your respective interests as tenants in common.

Tenancy in common

Tenancy in common means that each tenant may own an equal or

With a non-recourse mortgage, you are permitted to deduct the full balance of the non-mortgage against the value of the U.S. situs assets.

unequal share in real estate property. On the death of one tenant, only the deceased tenant's share in the property may be subject to U.S. estate tax, not the full value of the property. Each tenant passes their share in the property to their heirs named in their Will and not to the surviving tenants. 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. Some legal experts suggest that it is reasonable to reduce the fair market value of the property by approximately 20%. This reduction will decrease the value of your taxable estate and may reduce your exposure to U.S. estate tax.

Holding assets as tenants in common may pose certain ownership issues, especially where this form of ownership is used to own property 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.

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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 the interest in a RLT will not eliminate your exposure to U.S. estate tax, but each tenant can use a non-recourse mortgage for their respective share to minimize or potentially eliminate the U.S. estate tax exposure.

With a properly structured U.S. RLT you can potentially 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. The transferring of each spouse's interest to a properly structured U.S. RLT may be executed 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 personal-use U.S. assets, such as a vacation property, or if you are considering this kind of

strategy, you should be aware that this may not be a desirable ownership structure from a U.S. estate or income tax perspective. It is possible that the IRS may consider that the corporation is insulating the property from U.S. estate tax and disregard the structure. The property will be considered a U.S. situs asset of the shareholder. This may be the case, particularly if you 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. In addition, because the U.S. property is owned by a corporation, in the event of a sale the 15% preferential long-term capital gain rate for U.S. income tax purposes, which presently applies to individuals, trusts, estates and partnerships that own the property for more than a year, will not be available. Instead, the corporation will be taxed at a rate of up to 35% federally in the U.S. In some states, such as Florida, individuals are not subject to 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, 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. There is an administrative exception to this CRA policy 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.

Canadian partnership

Some experts suggest holding U.S. situs assets in a Canadian partnership with a family member instead of using a Canadian corporation. This complex strategy may make it possible to treat the Canadian partnership as a corporation for U.S. tax purposes, using what are referred to as "check the box" rules. This can potentially eliminate your exposure to U.S. estate tax, as previously mentioned, but the IRS 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 real estate property and not to carry on a business. The IRS may also assert that the partners have retained an interest in the real estate and have a right to redeem their partnership interest in exchange for the real estate property.

Since the structure will be viewed as a partnership for Canadian tax purposes, some of the negative Canadian tax consequences of owning U.S. real property inside a corporation, as previously discussed, may be avoided. However, if the structure is considered a corporation for U.S. tax purposes, the U.S. income tax treatment previously described may



The IRS may consider that the corporation is insulating the property from U.S. estate tax and disregard the structure.

still apply resulting in a higher rate of tax on the sale of the property.

Consult with a qualified tax advisor for more information before implementing this kind of strategy.

Canadian trust

U.S. real property may not be subject to U.S. estate tax if it is owned by a properly structured Canadian irrevocable inter-vivos trust. This strategy can be particularly beneficial if used by a married couple who establish the trust before the property is purchased. 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 your 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.

U.S. real property may not be subject to U.S. estate tax if it is owned by a properly structured Canadian irrevocable inter-vivos trust.

It is possible that transferring ownership of U.S. real property to a properly structured trust of this kind may potentially eliminate your exposure to U.S. estate tax. However the transfer of ownership will be considered to be a gift and it is therefore important to consider any U.S. gift tax and Canadian capital gain tax that may be triggered by the disposition. An alternative strategy is a U.S. revocable living trust, as discussed earlier in this article.

Since the structure is viewed as a trust for Canadian tax purposes, it is possible to avoid some of the negative Canadian tax consequences associated with owning U.S. real property inside a Canadian corporation. However, consider the potential impact of the deemed disposition by a Canadian-resident trust of all of its capital property that will occur on the 21st anniversary of the trust. You may be able to avoid the 21-year deemed disposition issue if a qualified spousal trust is used and children are not included as beneficiaries.

Conclusion

There are many factors to take into account in arriving at the most appropriate ownership structure for owning U.S. real estate. No single approach is right in all circumstances.

You should consider the Canadian income taxes and the U.S. income taxes, gift taxes and estate taxes that may apply. You should also consider your long-term intentions for the property. Give some thought to how long you wish to own the property and whether you want the property to be maintained for the benefit of future generations of your

family. Some individuals may find the administration required by some of the more complex solutions to be too complex to manage. These factors may help you choose an appropriate ownership structure for your U.S. real estate. It is important to consult a professional cross-border tax or legal advisor to review your specific situation.

Common U.S. real property ownership options for Canadians

This table 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.

Ownership Structure	Potentially Eliminates U.S. Estate Tax Exposure?	Complexity	Items To Consider
Rent	Yes	Low	No home ownership benefits
Sole owner	No	Low	U.S. state probate and guardianship issues in cases of incapacity
Tenants in common	May minimize	Low	U.S. state probate and guardianship issues in cases of incapacity Divided interest can be sold or bequeathed to anyone and may affect market valuation
JTWROS	No	Low	Avoids U.S. state probate on first death but may tax property twice in a generation
U.S. revocable trust	No	High	Divided interest can be sold or bequeathed to anyone
Canadian corporation	Yes *	High	Higher cost to set up; higher tax rate in U.S. on sale; Can be considered a shareholder benefit
Canadian irrevocable trust	Yes *	High	Settlor loses control; 21-year deemed disposition rule
Canadian partnership	Yes *	Highest	Higher tax rates in U.S. on the sale of property if treated as corporation

**If structured properly*

› Please contact us for more information.

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