FINANCIAL POST

If you die owning U.S. property or stock, beware the political football that is the U.S. estate tax

Most Canadians can buy a condo or vacation home in the U.S. for personal use, just bear in mind the potential U.S. estate tax if you die owning the property

The "Falcon Nest" in Prescott, Arizona, was on sale for US$1.5 million last year.

JAMIE GOLOMBEK
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Nearly every week I receive a frantic call from someone about to purchase a U.S. vacation property. They are panicking about the best way to structure the ownership of such a property. Should they 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 U.S. citizens living in Canada and non-U.S. citizens who own “U.S. situs property” upon death may be potentially caught by the U.S. estate tax.

RATES

For U.S. citizens, including dual Canadian/U.S. citizens living in Canada, the U.S. estate tax applies to the fair market value of their worldwide assets upon death. Rates start at 18 per cent and reach 40 per cent once assets are more than US$1 million. But most individuals 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 Jan. 1, 2018.

While President Trump’s original plan **called for a complete repeal of the estate tax, the final U.S. law stopped just 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 a U.S. (or dual) citizen 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.

For non-U.S. citizens, the estate tax only applies to individuals who 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

Canadians who are not U.S. citizens 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. High net worth Canadians who die owning U.S. situs property and have an estate larger than US$11.2-million may still have some exposure to U.S. estate tax.

PWC's Private Company Services group issued a bulletin this week on the 2018 U.S. estate tax rules for Canadians. The bulletin included an example of a high net worth individual, David, a Canadian resident (who is not a U.S. citizen), who 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.

But, 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.

Jamie.Golombek@cibc.com
Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Financial Planning & Advice in Toronto.