MoneySense

Estate planning tips for U.S. vacation homes

Estate planning is about aligning big picture plans with the details

by Romana King
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(Getty Images / Fuse)

A new survey by the U.S.-based National Association of Realtors (NAR) shows that a few number of cash-flush people flocked to the United States to purchase vacation property last year. (Read Monday's post for a great infographic that breaks down what this survey shows about U.S. investment and vacation homes in 2014)

With all this continued interest in U.S. vacation properties, you may be tempted to take the plunge and buy a property down south, but if you do there are a few details you'll need to keep in mind to stay on the good side of the U.S. and Canadian taxman.

CRA offers foreign tax credit

If you buy a U.S. vacation home and opt to rent it out—to either earn income or defray some of your annual expenses—then be prepared for double-taxation. That's because any income you earn in the U.S. must be declared to the Internal Revenue Service (IRS)—America's taxman, as well as to Canada Revenue Agency—our taxman. The good news is that Canada and the United States have a tax treaty, which means: "You can generally claim a foreign tax credit to reduce your Canadian tax," explains Jamie Golombek, CIBCs managing director of tax and estate planning.

A simple way to calculate what you owe is to comply with the 30% withholding tax the IRS puts on all foreign-owned income-generating properties. However, most real estate investors don't take this route as it doesn't allow them to take full advantage of all the deductible expenses that can be claimed to reduce your annual U.S. rental income and, thus, the taxes owed on that income. For those serious about earning a profit from U.S. investment properties consider finding a great cross-border tax specialist.

Change your principal residence

When a family owns more than one property they have options as to which property they'd like to designate as a principal residence, which entitles them to shelter the capital gains earned on the sale of that property from tax. It's called the principal residence exemption and, thankfully, it isn't limited to Canadian-owned property. "You will have to decide which of your properties would benefit the most from this exemption," explains Golombek. For more on how to maximize your PRE read this upcoming Friday's Home Owner posting.

Count your days

If you plan on using your U.S. property as a vacation home you'll want to keep in mind the number 183—that's the maximum number of days a Canadian can stay in the U.S. before they are considered a U.S. resident for tax purposes (as well as losing their Canadian resident status and health-care coverage). But be careful as the formula used by the IRS isn't simple. According to Fuller Landau's cross-border tax specialist, Frank Casciaro, the IRS uses a complex three-year formula that includes a third of the days you were in the U.S. the year before and a sixth of the days you were in the U.S. the year before that. "If that number exceeds 183 days then you're considered a resident of the U.S.," says Casciaro.

Prorate your estate (the taxman will)

A lot is written about the US$5.43 million exemption. This is the threshold for deciding whether or not your entire estate—Canadian property, stocks and everything else you own—is fully taxable by the IRS or not. The simple statement is that any Canadian who's entire estate is worth less than the threshold is exempt from having to pay U.S. taxes on their entire estate (although you'd still have to pay capital gains tax if you sold your U.S. property).

But this isn't actually true. The exemption does exist, but the threshold applies to U.S. citizens or U.S. residents. For a Canadian living in Canada and owning a vacation home in the United States, you do not get the full $5.43 million exemption. You get a prorated amount. In fact, any Canadian that dies with U.S. assets that are worth US$60,000 or more must file a tax return with the IRS.

Frank Casciaro, a senior manager for tax at Fuller Landau, explains that the IRS will look at the value of your U.S. property as a portion of the overall value of your worldwide estate. And that proration is what is applied against the exemption. So, here's an example of how this prorated formula works using a Florida condo worth US$150,000, an investment portfolio with US$50,000 in U.S. stocks and $500,000 in Canadian stocks, as well as a primary Canadian residence worth $850,000:

1) Your U.S. asset value (divided by) Your world-wide asset value (multiplied by) unified tax credit (based on tax treaty and is equal to $2,045,800) = Your prorated tax credit
2) Your U.S. assets (minus) $60,000* X .40 (tax rate) = Estate taxes
3) Estate taxes-prorated tax credit =Taxes owing

Example:
1) ($200,000/$1,550,000) X $2,045,800 = $263,974 –> your prorated unified tax credit.
2) ($200,000-$60,000) x 0.40 = $56,000 –> owed U.S. estate tax
3) $56,000 – $263,974 = $0 –> sum total of U.S. estate taxes owing

Keep in mind this is a simplified portfolio. For complex or large estates it's best to seek out a cross-border tax and estate planning specialist.

Watch out for deemed dispositions

In an effort to reduce U.S. estate tax, many Canadians will transfer U.S. investments, such as property or stock, into the hands of family members, such as adult-children. While this type of transfer may shelter or minimize your U.S. estate tax, and while it won't trigger U.S. gift tax it will trigger a deemed disposition for tax purposes in Canada—meaning you'll have to pay the capital gains tax that's triggered by this type of transfer.

Put it in your will

Make sure you put any U.S. property you own in your Last Will and Testament. "The U.S. will accept a Canadian will," explains Susan Mallin of Steinberg Wealth, "but it will still need to have a separate probate."

Also, if you will is in French and includes U.S. real estate, consider paying for a professional English translation. "U.S. probate will do it for you, but at a snail's pace and at a high cost," says Mallin.

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