MINDEN GROSS LLP BARRISTERS AND SOLICITORS
145 King Street West, Suite 2200, Toronto, ON M5H 4G2
P. 416.362.3711 ▪ F. 416.864.9223 ▪ @MindenGross ▪ www.mindengross.com

Canadians and US Real Estate

Matthew Getzler
Partner, Minden Gross LLP
T. 416.369.4316
mgetzler@mindengross.com

November 2012

On an individual's death, an estate tax is imposed in the US on both its citizens (based on their worldwide estates) and non-citizens (to the extent that they hold certain US-situs assets, including real estate therein). For US citizens (whether they live in the US or abroad), the first $5.12 million of worldwide assets are exempt from estate taxes, and worldwide assets in excess of this amount are taxed at a rate of up to 35%. Starting January 1, 2013, however, this exemption is scheduled to be reduced to $1 million and the estate tax rate is scheduled to increase to up to 55%. This is unless President Obama's proposed change to the estate tax regime becomes law (permanent exemption of $3.5 million and estate tax rate of up to 45%) or the Republicans win the upcoming election and introduce their own estate tax plan. (Individuals, however, should be wary of any change coming to fruition given previous instances involving the estate tax regime.) Non-US citizen Canadians who are subject to estate taxes, on the other hand, have their exemption "ground down" based on the proportion of their US-situs assets to their worldwide estate and are subject to estate taxes on the value of their US-situs assets in excess thereof. Thus, absent any changes, a Canadian's US-situs assets that comprise only 10% of his worldwide assets at death will only be entitled to an exemption of $512,000 in 2012 and $100,000 thereafter, and any US-situs assets in excess of this amount will be subject to estate taxes at a rate of 35% in 2012 or 55% thereafter.

So what's the impact of the estate tax on Canadians holding US real estate? Suppose Mr. Jackson has a worldwide estate of $15 million and is considering purchasing US real estate for $1.5 million or already owns US real estate worth $1.5 million. If the US real estate is Mr. Jackson's sole US-situs asset and if he holds it personally, on his death Mr. Jackson will be subject to estate taxes of roughly $345,800 in 2012; if he dies in 2013 or beyond, however, his estate tax will more than double to roughly $770,000.

Given the magnitude of those estate taxes, it's no wonder that many Canadians have been seeking alternative ways to hold US real estate to avoid estate taxes on death. Currently, one of the most frequent forms of alternative ownership is the use of a Canadian discretionary trust, the main, if not sole, purpose of which is to purchase and hold US real estate (whether from a third party or the individual himself). So long as the US real estate is held in this trust, the property will not form part of an individual’s estate and thus no estate taxes will be owing upon death with respect to the property. This type of trust is most commonly settled and funded - with the amount necessary to purchase the US real estate - by one spouse (the “grantor spouse”) while the other spouse (the “trustee/beneficiary spouse”) is often the sole trustee of the trust as well as a beneficiary thereof along with the couple’s issue. (The trust may also be used in a number of other circumstances including situations where there is only one spouse who will act as the grantor spouse.) The trust provides for discretionary payments of income and/or encroachments of capital to one or more of the beneficiaries, but such payments/encroachments are limited to the “ascertainable standard” (health, support in reasonable comfort, maintenance or education) unless an “Independent Trustee” is then acting, who can make unlimited payments/encroachments.

The major limitation of the trust is that the grantor spouse has no beneficial interest in the trust’s property and can only use the US real estate – while it is held in the trust – with the trustee/beneficiary spouse while he/she is alive. If the trustee/beneficiary spouse is the first spouse to die (or if there was only one spouse initially), the grantor spouse must pay fair market value rent to the trust in order to use the US real estate. And while the trust structure can be unwound if necessary (by distributing the property to one or more of the beneficiaries of the trust), the grantor spouse (because he/she is not a beneficiary of the trust) will forever extinguish his/her right to the US real estate as well as the funds used to acquire it. Another limitation is that the trust’s useful lifespan may be limited to 21 years as a result of certain Canadian tax laws that may give rise to significant Canadian tax consequences if the trust’s property is not distributed prior to its 21st anniversary. However, a number of factors will have to be considered at that time as, among other things, the potential estate tax exposure may outweigh the Canadian tax that will be triggered upon the trust’s 21st anniversary if the trust’s property is not otherwise distributed.

> **Tax Tip:** The US long-term capital gains tax is scheduled to increase in 2013 (although the extent of this increase is currently unknown). Accordingly, it may prudent for Canadians personally holding US real estate with accrued gains thereon to sell the property to the trust prior to the end of 2012.

When the US real estate has not yet been acquired, the use of a trust is relatively straightforward. Where US real estate is already owned, however, there are some additional factors that must be considered. In particular, capital gains taxes may be owing – in the US and/or in Canada – upon the sale of the property by the individual to the trust. In the US, long-term capital gains tax at a rate of 15% would be payable with respect to any gain (based on US values at the time of acquisition and time of sale) that is triggered upon the sale of the property. In circumstances that warrant the use of the trust, those US capital gains taxes will almost always pale in comparison to the potential US estate tax exposure.

As for Canadian taxes, a capital gain will be triggered on the sale (taxed at a rate of up to almost 24% in Ontario in 2012) to the extent the fair market value of the US real estate (adjusted for the exchange rate at the time of the sale) exceeds its cost base (adjusted for the exchange rate at the time of acquisition). As a result of the adjustments, however, it is possible that no Canadian capital gains taxes will be owing upon the sale in spite of increases in the value for US purposes and it is likewise possible that Canadian capital gains taxes will be owing upon the sale even though there has been a decrease in value for US purposes. In any event, if Canadian capital gains taxes are owing on the sale, some or even total relief may be available (i.e., foreign tax credit, principal residence exemption).

For further information, please contact the author or any member of the Minden Gross Tax or Wills & Estates groups. Many thanks to Michael Goldberg of Minden Gross LLP and Katherine Cauley of Hodgson Russ LLP for their assistance in the preparation of this article.

For more information, please contact Matthew Getzler – mgetzler@mindengross.com.