

# FOCUS

## ON CROSS-BORDER LAW

# Residence trusts

## How to eliminate estate tax for Canadian owners of U.S. real property



**KATHERINE  
CAULEY**

For many Canadians, the southern U.S. is a favorite vacation destination. Now, the strong Canadian dollar and favourable real estate markets have made purchasing a vacation home in the U.S. even more attractive. But owning U.S. real property can be a tax trap for the unwary.

Canadian owners of U.S. real property are exposed to U.S. estate tax on the full fair market value of the property at death, at rates as high as 45 per cent. But planning with a properly structured residence trust can eliminate U.S. estate tax completely.

### Prorated exemption

A Canadian citizen and resident is subject to U.S. estate tax only on his or her U.S. situs assets. U.S. situs assets include, among other things, real property physically located in the U.S.

Relief is available under U.S. domestic law, but it is limited. Under the U.S. Internal Revenue Code, the estate of a non-resident non-citizen (NRNC) is allowed a credit which exempts \$60,000 of U.S. property from U.S. estate tax. Additional relief is available under the Canada-U.S. Treaty, and more specifically, the 1995 protocol to the treaty. Under the protocol, an NRNC is entitled to an expanded credit which yields a potentially greater exemption amount based on the ratio of the decedent NRNC's U.S. situs assets to his or her worldwide assets (the "prorated exemption").

The prorated exemption is calculated by multiplying the exemption amount afforded a U.S. citizen (currently U.S. \$2 million) by a fraction, the numerator of which is the value of the NRNC's U.S. situs assets and the denominator of which is the NRNC's worldwide assets.

### Marital exemption

The treaty also allows a marital exemption equal to the prorated exemption. If a married NRNC dies owning U.S. situs assets and leaves it to his or her spouse in a manner that would qualify for the U.S. marital exemption if the sur-



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Canadian owners of U.S. vacation properties can attract high U.S. estate taxes.

living spouse were a U.S. citizen, the exemption amount is effectively doubled.

In some cases, planning for the use of the prorated exemption and the marital exemption can alleviate all or most of the U.S. estate tax exposure at the NRNC's death, although special planning may still be needed to minimize the U.S. estate tax exposure in the surviving spouse's estate. A properly structured residence trust eliminates both the risk that the treaty credits will not shield the full fair market value of the property in the NRNC's estate and the need for special planning for the surviving spouse, because it eliminates the U.S. estate tax exposure altogether for both spouses.

### Residence trusts

A residence trust structure can be used in many situations, but it works most effectively for a married couple. One spouse (the "grantor spouse") creates the trust and provides to the trustee the funds to purchase the property. Neither the creation of the trust nor the funding is taxable for U.S. gift tax purposes.

Title to the real property is taken in the name of the trust. To avoid inclusion in the grantor spouse's estate for U.S. estate tax purposes, the grantor spouse may not be a beneficiary or a trustee. However, it is permissible for the grantor's spouse to be the trustee provided distributions are limited to what is known as an ascertainable standard — typically, health, support, maintenance or education.

As a practical matter, if the property is held for personal use, there will be no distributions, but inclusion of the ascertain-

able standard is critical if the spouse acts as trustee.

The trust beneficiaries are the grantor's spouse and descendants who may have rent-free use of the property during their lives. The grantor spouse may also enjoy rent-free use of the property during the spouse's lifetime. On the death of the grantor, the value of the property is not included in his or her estate for U.S. estate tax purposes. The spouse continues to enjoy rent-free use of the property until the spouse's death. As with the grantor, the value of the property is not included in the spouse's estate for U.S. estate tax purposes.

### Maintenance

The trust may be structured so that the beneficiaries provide for the maintenance (including ordinary repairs) of the real property, or the grantor may contribute additional funds to the trust to cover expenses. Capital improvements, however, should be undertaken only with funds contributed to the trust by the grantor.

If the property is held for personal use (meaning there is no income earned by the trust), there are no U.S. tax filing requirements. Further, if the property is held for more than one year, then the U.S. capital gains rate (currently 15 per cent, versus 34 per cent for real property held by a corporation) applies if the property is sold.

The residence trust does have a few disadvantages. First, if the grantor's spouse predeceases the grantor, then the

## Grantor spouse excluded if parties divorce

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grantor spouse must pay rent to the children in order to continue using the property. Of course, if the grantor intends to continue to maintain the property in any event, this may not be overly burdensome. Second, if there is a divorce, the beneficiary spouse may continue to use the property to the exclusion of the grantor.

The residence trust has good upside potential and very little downside. For Canadians contemplating purchasing U.S. real property, the residence trust is an effective mechanism for avoiding U.S. estate tax.

*Katherine Cauley, a lawyer at Hodgson Russ LLP, concentrates her practice in estate and trust law and Canada/U.S. cross-border tax and estate planning.*

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