US TAX REFORM AND US REAL ESTATE

Canadian Tax Highlights
October 25, 2018

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This article was originally published in the Canadian Tax Highlights *Volume 26, Number 10, October 2018. Reprinted with permission.*

As is now well publicized, the Tax Cuts and Jobs Act (TCJA), signed into law by President Trump on December 22, 2017, significantly increased the US estate and gift tax exemption for US persons, inflation-indexed to $11.18 million for 2018. This increased exemption applies from 2018 until December 31, 2025, when the US exemption reverts to the pre-TCJA level of US$5 million per person (indexed for inflation). The maximum rate for US estate tax remains at 40 percent of the taxable assets' FMV.

For a Canadian who owns US-situs assets, the TCJA effectively doubles the prorated US estate tax exemption under the Canada-US treaty until the end of 2025. Under the treaty, a Canadian citizen and resident is entitled to a prorated US estate tax credit, which is calculated as the estate tax credit for a US person ($4,417,800 on an $11.18 million exemption) multiplied by the decedent's US-situs assets' value over his or her worldwide assets' value. The TCJA also effectively doubles the treaty's marital credit, now equal to the prorated estate tax credit of a Canadian citizen who dies owning US-situs assets, if he or she leaves them to a surviving spouse in a qualifying manner.

The TCJA provides an opportunity for many Canadians with US-situs assets to simplify their US estate planning. Perhaps the most common example is a Canadian who wants to purchase US real estate and the inevitable discussion of how to take ownership. Forms of ownership that were previously discouraged owing to the possibility of US estate tax exposure and the higher US corporate income tax rates may warrant a second look, particularly for Canadians whose worldwide net worth falls significantly below the current US exemption. The following enumerates some possibilities that are perhaps more suitable now.

Personal ownership. Under the treaty, the estate of a Canadian citizen and resident who dies owning US real property before 2026 does not owe US estate tax if his or her worldwide estate is less than the current US$11.18 million exemption: the exemption limit is essentially doubled if the estate passes to a Canadian surviving spouse on death. Thus, many individuals of moderate wealth who are considering buying US real property find that personal ownership is now the simpler option.

However, caveats accompany the simplicity and low cost. First, a US non-resident estate tax return (IRS form 706-NA, "United States Estate [and Generation-Skipping Transfer] Tax Return") must still be filed on the owner's death to claim the treaty-prorated exemption (assuming that the US property is worth at least $60,000), even if no US estate tax is owing. (A common misconception exists that US filing is not required if the Canadian decedent falls below the current US exemption at death.) Second, US ancillary probate is required on the death of an individual owner.

Canadian limited partnership and check the box. Because the top US corporate rate is reduced to 21 percent, the use of a Canadian limited partnership that checks the box to be taxed as a US corporation may be an alternative for taxpayers whose fact patterns do not fit well with the typical irrevocable trust structure (such as single high-net-worth individuals and second marriages). The formation and annual compliance costs are typically higher with the limited partnership structure, but that structure may allow more control and flexibility than the typical trust.

Irrevocable trust. This is the most common structure for the typical US vacation personal-use property. An irrevocable trust drafted for US estate tax purposes can protect against that tax, provide both Canadian and US beneficial capital gains rates on a sale, and avoid US probate and any post-death IRS estate tax filings. Limitations of such a trust include the 21-year rule and the fact that certain family situations may not fit the necessary fact pattern.

Corporate ownership. Holding US real estate was previously not favoured for a Canadian corporation because the higher US corporate income tax rate applied on the property's future sale: a Canco may now be an option because the US corporate rate is 21 percent, especially if the funds for a proposed purchase are already trapped in the Canco. However, for personal-use properties, Canadian shareholder benefits must be addressed.

It must be remembered that these TCJA individual tax cuts are scheduled to expire in 2026 and revert to pre-TCJA levels, unless made permanent by future US legislation: long-term planning is thus mired in uncertainty. However, the current law provides many opportunities to explore new alternatives for the common fact pattern of a Canadian who wants to purchase US real estate.