

## US Estate Tax Savings

Increasingly, Canadians are purchasing real estate in the United States in order to take advantage of the current US real estate market and low interest rates. Planning is required to reduce or eliminate exposure to US estate tax for a Canadian who owns US real estate outright. Although Canadian individuals and their advisers frequently inquire about the appropriate method of acquiring US real estate, in many cases the question is asked after the purchase transaction has been completed. Fortunately, although implementing the proper structure at the outset is the best practice, planning opportunities exist even for a completed transaction.

If a Canadian citizen and resident owns US real property at his or her death, it is US-situs property and potentially subject to US estate tax on its full value at rates up to 45 percent (2009). Under the Canada-US treaty, a Canadian citizen-resident qualifies for a US estate tax exemption equal to

$$\text{US citizen's } \$3.5 \text{ million estate tax exemption (in 2009)} \times \frac{\text{Value of decedent's US-situs assets}}{\text{Value of decedent's worldwide assets}}$$

In many cases, the available exemption is insufficient to prevent US estate tax exposure. This is commonly the case if a couple has significant wealth located outside the United States; however, with proper planning and structuring, a residence trust can avoid exposure.

In a typical residence trust structure for a married couple, one spouse (the grantor spouse) creates and contributes funds to a trust of which the grantor's spouse and descendants are the beneficiaries. If specific requirements and procedures are followed, the trust structure avoids the inclusion of the US-situs real property in either spouse's estate for US estate tax purposes. Moreover, a properly implemented residence trust structure also qualifies for the current 15 percent US long-term capital gain tax rate on the property's future sale and avoids the Canadian shareholder benefit rule.

It is preferable for the trust to purchase the US property at the outset; but even if the Canadian purchaser seeks advice after having purchased the US property personally, with a few additional planning steps the residence trust technique can still be effective if a subsequently established residence trust later purchases the property from the individual. To minimize the US estate tax exposure, the sale transaction must be structured with terms that are as close to arm's-length as possible. Any gain from the sale is subject to withholding tax under the FIRPTA rules. State transfer tax on the sale price may also be exigible at the time of closing. The Canadian individual must also include the gain on the sale in his income for Canadian tax purposes; the US tax is creditable against the higher Canadian tax, and the residual balance must be paid. Given the depressed US real estate market, many properties can be sold at no gain or even at a loss. The time is thus opportune for a Canadian who already owns US real estate personally to consider a sale to a residence trust in order to achieve substantial US estate tax savings.

To effect a sale transaction to a residence trust, a Canadian citizen-resident must, inter alia, (1) obtain a current fair market appraisal for the US property; (2) document the original cost and capital improvements to determine basis; (3) prepare and finalize the residence trust agreement and fund the trust; (4) retain local counsel to prepare a contract of purchase and sale whereunder the residence trust's trustee contracts with the individual to purchase the US real property; (5) apply for an IRS withholding certificate (form 8288-B) so that the FIRPTA withholding tax is based on the actual amount of the gain, rather than the 10 percent of the purchase price otherwise required; and (6) file a US non-resident income tax return (form 1040NR) by June 15 of the following year to report the property's sale.