FAQS ON U.S. LEGAL TOPICS OF INTEREST TO CANADIANS – RESIDENCE TRUST

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Practices & Industries

Canada-U.S. Cross-Border

Question: My husband and I are Canadian citizens living in Oakville. We are thinking about purchasing a second home in Florida, but we are concerned that this purchase might expose us to significant U.S. estate taxes. Is there anything we can do now to protect our estate?

Answer: Yes. U.S. estate tax exposure may be avoided through the proper use of a residence trust. A residence trust can be used in many situations, but it works most effectively for a married couple like you. The structure avoids the inclusion of the U.S. real property in either spouse's estate for U.S. estate tax purposes if specific requirements are met.

With the residence trust approach, one spouse would be the settlor/grantor of the trust and contribute all the funds toward the purchase of the property. The trust would be for the benefit of the grantor's spouse and descendants, and the trust would acquire the property. The trust agreement generally would provide that (1) the beneficiary spouse is the trustee (the grantor spouse cannot be the trustee), (2) the beneficiary spouse and descendants have lifetime, rent-free use of the property, and (3) distributions from the trust can be made to the beneficiaries subject to an ascertainable standard. The property needs to be purchased by the residence trust at the outset and cannot be transferred to such a trust thereafter without raising U.S. income, gift, and (other) estate tax issues.

The residence trust also has significant U.S. income tax advantages as it potentially allows the long-term capital gains rate (applicable to property held for more than one year) to be available on a sale. This rate is presently 15 percent federally, whereas the ordinary income and short-term capital gains rates for individuals are at a maximum rate of 35 percent federally. Ownership of U.S. real property by a corporation, for example, does not permit use of a lower capital gains rate on a sale of the property — instead, the regular corporate rate (34 percent federal) applies. In Florida, there is also a state income tax for corporations but not individuals. Therefore, there is a significant tax rate differential on a sale of capital gain property by an individual (15 percent, federal only) as opposed to a corporation (about 40 percent, federal and state). The residence trust also has creditor protection benefits.

There are certain disadvantages with the residence trust approach in the event of divorce or if the beneficiary spouse dies before the grantor spouse. These disadvantages can be minimized with proper drafting of the trust agreement.

If the property is going to be rented to third parties, a limited partnership should be considered in conjunction with the residence trust approach to give the owners additional liability protection.

The Florida real estate market welcomes you with open arms, and with appropriate planning, you can keep your U.S. estate tax exposure to a minimum.