

U.S. Vacation Property - Look Before You Leap



Canadians are looking south of the border for winter vacation properties. The sunbelt beckons with sunny skies and balmy temperatures. The combination of our relatively stronger domestic economy, high Canadian dollar and soft U.S. real estate market makes acquiring and holding U.S. vacation property a reality for many Canadians. But, before you sign on that dotted line, there are U.S. federal and state taxes that must be considered and planned for in conjunction with Canadian tax laws.

A Canadian who owns a U.S. vacation property will be subject to U.S. income taxes on sale and U.S. estate taxes on death. However, with proper planning these taxes can be minimized, structured to maximize Canadian foreign tax credits, or even possibly eliminated.

U.S. income tax is payable on sale of a U.S. vacation property held personally at generally 15% federally and, depending on the State of the property, at approximately 5-8%. A Canadian resident is liable for Canadian taxes on the sale, at

generally 20-22% (depending on province or territory of residence). Generally, no double taxation should result as Canada allows a foreign tax credit for U.S. taxes paid or payable equal to the Canadian tax otherwise owing.

U.S. Estate Tax

U.S. federal law and many of the individual states impose an estate tax on death. The amount subject to tax is calculated on the fair market value of a decedent's gross estate. For non-U.S. persons, the amount of gross estate subject to U.S. estate tax includes U.S. real property, stocks of U.S. companies, any debt obligations of U.S. persons and an interest in a U.S. trust, for example. Under the U.S. system the rate of tax applied to the taxable estate is on a graduated scale from 18% to a top rate of 45%. A credit, called the unified U.S. estate tax credit, is allowable to exempt estates with assets of less than US\$2M from the imposition of estate tax. Canadian residents are able to claim this credit but it is prorated by the formula of U.S. assets to worldwide assets.

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Provincial / Territorial Budgets

Yukon

Dennis Fentie, Premier of Yukon, delivered the 2008/2009 budget, which focused on improving the health, safety and socio-economic well being of Yukon families and their communities. No new tax measures were introduced.

The 2008-2009 Budget focused on enabling the Government of Yukon to implement initiatives in four key pillars: a better quality of life, a pristine environment, a diversified private sector economy, and good governance. The Premier noted that “Yukoners enjoy a quality of life second to none in Canada. The Yukon Economy is growing and becoming more diversified. Progress is being made in addressing the challenges of climate change and Yukon is being viewed as a model in Canada of cooperative governance and strong fiscal management”.

Northwest Territories

On May 22, 2008, the Premier and Finance Minister, Floyd Roland, delivered the Territory’s 2008-2009 Budget. No new taxation measures were announced, although the Premier did applaud the 2008 Federal Budget measure increasing by 10% the residency component of the Northern Residents Deduction, effective 2008.

The Premier noted: “We continue to have the highest Gross Domestic Product per capita in the country. And the highest average income in the country. At the end of last year, a third world-class diamond mine went into production in the Northwest Territories. At full operation, our diamond industry will produce 15 per cent of the world's diamonds. For a territory of only 43,000 people, those are some great achievements”.

Alberta

The Alberta Minister of Finance, Iris Evans, presented the 2008-09 provincial budget on April 22, 2008. The following personal and corporate measures were announced:

Business Measures:

- Although not a new tax measure, the budget reiterated that the amount of income that can be earned for the small business rate of three per cent was increased from \$430,000 to \$460,000 effective April 1 2008. It will further increase to \$500,000 on April 1, 2009.
- A new 10 per cent provincial credit for scientific research and experimental development will take effect January 1, 2009, to promote Alberta as a knowledge-based economy. The refundable credit will be worth 10% of a company’s eligible expenditures up to \$4 million, for a maximum credit of \$400,000.
- Alberta is paralleling federal changes to the Capital Cost Allowances. These changes include an extension of the accelerated rate for manufacturing and processing equipment, and increases to the rates for certain types of clean energy generation equipment, railway locomotives and carbon dioxide pipelines and related equipment.
- The government will introduce legislation to effectively increase the tax on income subject to the higher Alberta small business thresholds that are withdrawn under the enhanced dividend tax credit, from 3% to 10%.

Alberta Budget

Individual Measures:

- The elimination of the health care premiums, effective January 1, 2009, will benefit Albertan families by \$1,056 each year, and by as much as \$528 per year for single persons. The annual saving is estimated at \$1 billion.
- Personal tax credits will be indexed in 2008 by 4.7%, which would, for example, increase the basic/spousal and eligible dependant credits from \$15,435 to \$16,161. In total, this will save \$132 million in 2008.
- The Alberta Family Employment Tax Credit will be enhanced by \$25 million, increasing the credit, depending on the number of children in the family, and increasing the phase-out income threshold to start at \$32,633.
- The caregiver credit and infirm dependant credit will more than double, resulting in benefits of between \$500 and \$1,000 annually.
- Alberta will parallel the recent federal budget introduction of the tax-free savings account, which comes into effect in 2009, so that income earned in the account is not subject to Alberta tax.

International Financial Reporting Standards (IFRS) Are Coming

In this era where even small enterprises are doing business around the world, the importance of uniform financial reporting has become apparent. In recent years a call has been made for financial reporting to be harmonized through the adoption of International Financial Reporting Standards (IFRS).

In Canada, the move to IFRS from Canadian GAAP (Generally Accepted Accounting Principles) will

fundamentally change the way businesses report their financial results. The new IFRS rules could also affect the measurement and reporting of income taxes for financial statement purposes and the calculation of Canadian taxes payable.

It has been proposed by the Accounting Standards Board that IFRS be effective for interim and annual financial statements for publicly accountable entities for fiscal years beginning on or after January 1, 2011, although that date has yet to be finalized. In addition, the impact on privately-held entities has yet to be decided.

Accounting professionals are working on a framework for the transition to IFRS. Please contact your local MacKay LLP office for information on how this transition may affect your company's financial reporting.

CRA Executes Significant Tax Fraud Investigation

Over 300 CRA investigators and officers have been executing search warrants across western Canada. The searches were conducted at over 50 separate locations as a result of alleged involvement in fraud related to fictitious Registered Retirement Savings Plans, investment scams, and other tax evasion.

A CRA news release cautions taxpayers to check the legitimacy of RRSP funds and investment opportunities before making any contributions: "Canadians should know that they are responsible for taxes and interest owed on taxes evaded, even if a promoter indicates otherwise".

Moral of the story is that if it sounds too good to be true, it probably is. The worst of the RRSP scams has resulted in taxpayers losing their retirement savings to fraudsters, while still having to pay personal income tax and accrued interest and penalties on the amounts withdrawn from their RRSPs.

Please contact your MacKay LLP tax advisor before committing to any investments that promise a return all or partially based on tax savings.

Estate Planning

Alter Ego Trust Beats Wills Variation Act

The Mordo decision of the Supreme Court of British Columbia (2006 BCSC 1761) is good news for individuals and estate planners who have used alter ego and joint spousal trusts as a protective measure to ensure an orderly transition of assets in an estate situation.

Parents may be concerned that certain family dynamics may cause their will to be challenged by a disgruntled relation under the provincial Wills Variation legislation. One way to minimize this concern has been through the use of alter ego and joint spousal trusts. As the assets would technically not pass through the will to the beneficiaries, but rather would pass to the designated beneficiary through the operation of the trust, legal thought has been that the estate would be protected from such challenges.

The Mordo case is one of the first cases to test this legal thought. The case is an epic treatise on the law relating to alter ego trusts, the Wills Variation Act, deeds of gift, the use of joint tenancy to transfer assets, as well as a variety of other interesting estate planning issues.

The fact pattern in the case involves a not so uncommon family situation where the parents are determined to favour one of their children over another in their estate planning. In this case, Alexander Mordo, their son, had more than sufficient assets on which to live and, therefore, the parents determined to give all of their estate to their daughter Viviane Nitting who had long cared for them. Due to the fact that Alex and Viviane had been estranged most of their adult lives, the parents feared that Alex would attempt to challenge any will favouring Viviane and accordingly took extensive advice in order to prevent that from happening. In the end, the careful planning paid off as the court's findings completely favoured the daughter.

If you are dealing with similar circumstances, this case makes it clear that a properly created alter ego trust will trump the Wills Variation Act. Also, as provincial probate fees are incurred on the value of assets transferred through a will, the use of such trusts could also technically eliminate probate fees.

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The estate of a Canadian decedent whose U.S. assets pass to their spouse is also able to claim a marital credit equal to the unified credit available.

Accordingly, proper planning will include the minimization of U.S. estate tax. Such plans may include the use of debt, donations, life insurance, trusts and/or spousal ownership.

Structures for Purchase of U.S. Vacation Property

Direct ownership

Direct individual ownership of U.S. real property may be appropriate for a Canadian who is relatively young and healthy without significant personal assets and whose U.S. estate tax liability is comparatively small. The estimated U.S. estate liability can be covered through the purchase of term life insurance, which may be practical where the insurance is inexpensive to purchase and administer. As well, the use of a Canadian insurance trust may be advantageous for persons with sufficient net worth.

Where the ownership is to be held by both spouses, joint tenancy is not recommended due to complexities for U.S. tax purposes on the creation or termination of a joint tenancy. Tenancy in common may be advisable where both spouses have contributed equal funds to the purchase of the property.

Direct ownership may also be practical where significant non-recourse debt is incurred to purchase the property. Generally speaking, for a debt to qualify as non-recourse debt the lender may only look to the property to recover on the debt.

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Ownership through a trust

A properly structured irrevocable Canadian discretionary trust can eliminate U.S. estate tax liability on a U.S. vacation property. These types of trusts are advisable for high net worth individuals who intend to pass the property to their spouse and heirs, spouses with significant gaps in their net worth or age, or persons who are not able to obtain life insurance.

The structuring, maintaining and provisions of the trust must meet specific criteria for Canadian and U.S. tax purposes to qualify.

The advantage of a properly structured trust is that on the death of either spouse no estate tax is payable. Furthermore, on the sale of the property held by the trust, either before or after death of the Canadian spouses, beneficial U.S. federal and state long-term capital gains rates may be available that compare to the rates afforded to individuals and mirror Canadian taxes otherwise payable.

Canadians who already own U.S. vacation property

Many Canadians already own U.S. vacation property and may not have sought tax advice in advance of their purchase and may be caught with potentially large and unintended U.S. estate tax consequences.

The simplest solution in these circumstances may be through the use of term life insurance, if available and reasonable in cost, to provide for the U.S. tax liability.

Where life insurance is not practical, estate tax planning involving the use of a qualified domestic trust, often called QDOT, may provide a solution for property intended for the use of a spouse. Where an individual owns a U.S. vacation property and that property on death is transferred to a QDOT for the use of the spouse and meets certain other tests, the estate tax otherwise payable is deferred until the earlier of the death of the surviving spouse or distribution of the trust principal to the surviving spouse. However, the use of QDOT eliminates the

ability to claim the marital credit previously discussed.

If a Canadian gifts U.S. vacation property, U.S. federal and state gift tax may apply. The gift tax applies to the taxable amount of the gift at graduated rates ranging from 18% to 47% with annual exemptions of \$11,000 to recipients other than a spouse and \$117,000 for a non-U.S. spouse. For Canadian tax purposes, gifts of appreciated property to a non-spouse results in a taxable capital gain of the difference between the fair market value and cost of the appreciated property. Unfortunately, U.S. gift taxes are not creditable for Canadian purposes, possibly resulting in double taxation.

U.S. residency and domicile issues for Canadians

Many Canadians spend much of the fall and winter season in the U.S. without consideration for potential U.S. tax disclosure filing obligations or potential U.S. income and/or estate tax consequences. Where a non-resident is considered a U.S. person, they could be subject to U.S. taxation on their worldwide income, estate taxation, and onerous reporting of ownership of non-U.S. corporations and bank accounts. Failure to comply with these rules can result in significant penalties.

Under the U.S. tax system a non-resident may be considered a U.S. person for tax purposes if they meet either of two tests; (1) physical presence or (2) substantial presence.

Under the physical presence test, a non-resident is considered a U.S. person if they are in the country for 183 days in any given fiscal year, whereas under the substantial presence rules, a non-resident meets the residency test if they are in the U.S. for a certain number of full or part days over a three year period as calculated by a formula.

Relief may be available for those individuals who meet the substantial presence test in a given year but are able to prove that they have a closer connection to a country other than the U.S. and they must file a statement with the Internal Revenue Service claiming such relief.

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What's New At MacKay

Congratulations to Our New Designates: We Are Proud of Your Accomplishments

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These efforts yield talented new CAs, CGAs and CMAs each year. To date in 2008 we are pleased to recognize the accomplishments of our newest designates:

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