CIBC PRIVATE WEALTH

U.S. VACATION PROPERTY PLANNING FOR CANADIANS

October 20, 2021
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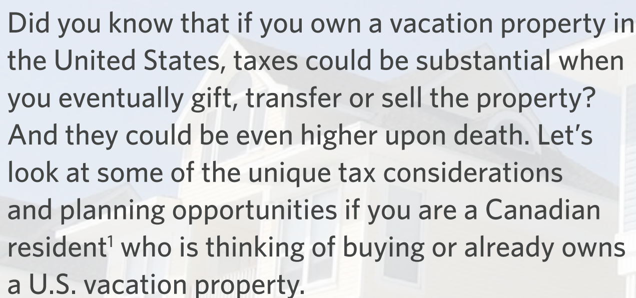

Did you know that if you own a vacation property in the United States, taxes could be substantial when you eventually gift, transfer or sell the property? And they could be even higher upon death. Let's look at some of the unique tax considerations and planning opportunities if you are a Canadian resident[1] who is thinking of buying or already owns a U.S. vacation property.

Transferring your U.S. vacation property during your lifetime

A "transfer" for tax purposes can include both a sale and gift of your property. In both Canada and the U.S., you may pay tax on the capital gain if you sell your U.S. vacation property for more than its cost, which also includes amounts you paid for improvements.

The maximum U.S. federal tax rate that you could pay is 20% on long-term capital gains, for properties owned for more than one year; otherwise, graduated U.S. federal income tax rates range up to 37% for short-term capital gains.[2] If you're not a U.S. person, the purchaser of your U.S. vacation home is generally required to withhold 15% of the gross proceeds and remit this withholding tax to the U.S government on your behalf.[3] You may claim amounts withheld by the purchaser as a credit against U.S. tax owing on capital gains.

One half (50%) of any capital gain may also be taxable in Canada at graduated federal and provincial tax rates. Any capital gain (or loss) must be calculated in Canadian currency, using exchange rates at the time the property was purchased and sold. You can then claim a foreign tax credit for taxes paid in the U.S. against the tax liability in Canada (if any).

If you're thinking of gifting (rather than selling) your U.S. vacation property, perhaps to a family member so it can be enjoyed by future generations, you should be aware that the U.S. gift tax regime and special Canadian tax rules could result in a significant tax bill in both countries, without appropriate planning.[4]

[1] Note that this report only covers tax planning for non-U.S. persons. If you are a U.S. person (including a U.S. citizen), be sure to consult a U.S. tax advisor as the rules and planning opportunities are significantly different.
[2] Although state and local taxes may apply to transfers of your vacation property, they are not considered in this report.
[3] If the purchaser acquires property for use as a residence, no withholding is required when the proceeds of sale are under USD$300,000, and a 10% rate applies for proceeds up to USD$1 million. In some cases, such as when the ultimate income tax liability is expected to be less than the withholding amount, you may apply to the IRS for a withholding certificate that would allow the purchaser to reduce or eliminate the amount withheld.
[4] More details are available in the report, "Your U.S. vacation property could be quite taxing", which is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/us-vacation-property-en.pdf.

Tax planning strategies

Here are some tax planning strategies to consider:

- Hold onto receipts to validate amounts you have paid for capital improvements to the property. These amounts may generally be added to the tax cost of the property (the adjusted cost base or ACB), potentially reducing the capital gain and related taxes upon transfer or sale or death.
- Consider holding your property for at least one year, to access the lower 20% U.S. long-term capital gains tax rate.
- In Canada, you may be able to claim the principal residence exemption (PRE) to reduce or eliminate any taxable capital gain; however, if you have more than one home during a year, you will have to decide which should benefit from the PRE.
- If there is a capital loss on the sale of your U.S. vacation property, this is generally denied as its considered personal use property.
- Prior to making any gifts of U.S real estate, be sure to consult with Canadian and U.S. tax and legal professionals to avoid costly pitfalls.

Estate planning considerations

U.S. estate tax may apply at graduated rates ranging from 18% to 40% on the value of a U.S. vacation home that you own upon your death. There is an estate tax exemption that may eliminate your estate tax bill if the value of your gross worldwide estate, including your U.S. vacation home, is under USD$11.7 million in 2021.[5] If the value of your worldwide estate exceeds this threshold, U.S. estate tax may be payable.

For Canadian tax purposes, there is no estate tax. Instead, you will be treated as if you sold your U.S. vacation property upon death, which could result in a capital gain (as above). A foreign tax credit may be claimed for U.S. estate tax paid on your vacation property on your Canadian return.

AN EXAMPLE OF TAXES ON A U.S. VACATION PROPERTY UPON DEATH

Let's say you bought a U.S. vacation home for USD$4 million when USD$1.00 equaled CAD$1.25 so you paid CAD$5 million. Suppose that when you die your home is worth USD$5 million and you have USD$20 million of other assets in Ontario, where you pay tax at the top marginal rate.

Based on the USD$5 million value of your U.S. home and your worldwide estate of USD$25 million, the U.S. estate tax on your vacation home would be USD$1,020,640.[6] There would be no U.S. tax on the USD$1 million capital gain that arose during your lifetime, either for you or your heirs, due to a step-up in basis upon death.

Suppose that when you die, the foreign exchange rate is still USD$1.00 equals CAD$1.25. In U.S. dollars, there would be a capital gain of USD$1 million. For Canadian tax purposes, however, there would be a capital gain of CAD$1,250,000[7], which would result in CAD$334,563[8] of tax. Although the PRE could be claimed to eliminate the capital gain, it would be better to claim a foreign tax credit based on the USD$1,020,640 (CAD$1,275,800[9]) of U.S. estate tax – this would eliminate Canadian taxes on your U.S. home while preserving the PRE for another home. Since the foreign tax credit would completely eliminate Canadian taxes payable, the combined U.S. and Canadian taxes owing on your U.S. vacation property would be equal to the U.S. estate tax of CAD$1,275,800.

But what if there was a change in the exchange rate? Suppose that when you die, USD$1.00 equals CAD$1.00. For Canadian tax purposes, there would be no capital loss or capital gain[10], so there would be no tax payable in Canada on your U.S. vacation property. No foreign tax credit could be claimed for the USD$1,020,640 (CAD$1,020,640) of U.S. estate tax that is payable. Since there would be no Canadian taxes payable, the combined U.S. and Canadian taxes owing on your U.S. vacation property would still be equal to the U.S. estate tax, which would be CAD$1,020,640.

[5] A married individual who leaves U.S. situs assets, including U.S. real estate, to a surviving spouse may claim a marital credit so that a worldwide estate up to USD$23.4 million (2021) may be sheltered from U.S. estate tax.
[6] Calculated as gross estate tax of USD$1,945,800 minus [USD$5 million divided by (USD$5 million plus USD$20 million) times the 2021 unified credit of USD$4,625,800].
[7] Calculated as (USD$5,000,000 times CAD$1.25) minus (USD$4,000,000 times CAD$1.25).
[8] Calculated as CAD$1,250,000 times 50% times 53.53%.
[9] Calculated as USD$1,020,640 times CAD$1.25 divided by USD$1.00.
[10] Calculated as (USD$5,000,000 times CAD$1.00) minus (USD$4,000,000 times CAD$1.25).

Some estate planning strategies

Here are some estate planning strategies to consider:

- You may wish to gift some of your assets during your lifetime, to reduce the value of your worldwide estate that is used in U.S. estate tax calculations. Note that gifting certain U.S. assets may result in U.S. gift tax or immediate tax in Canada on any accrued capital gains.
- You could purchase life insurance to cover any tax liability upon death. Note, however, that the value of the life insurance will generally be included in the value of your worldwide estate when calculating U.S. estate tax. To mitigate this, consideration could be given to having the life insurance proceeds flow into a life insurance trust.
- "Non-recourse" debt, which is secured only by the property and not your other assets, could be used to finance your U.S. home. This would reduce the value of the property for U.S. estate tax purposes. Practically, however, it may be difficult to find a lender offering this type of debt.
- You could consider holding your U.S. vacation property indirectly, perhaps through a family trust or partnership, which may eliminate U.S. estate tax. These are advanced strategies that should be discussed with Canadian and U.S. tax and legal advisors.

Proposed U.S. tax changes

U.S. President Joe Biden has proposed a number of changes[11] that could significantly increase the U.S. federal taxes on your vacation property. Among the proposed changes:

- The maximum income tax rate, which applies to short-term capital gains, would increase from 37% to 39.6%.
- For taxpayers with taxable income over USD$1 million, the tax rate on long-term capital gains would increase from 20% to 39.6%.
- In 2022, the U.S. estate tax exemption would be decreased from USD$11.7 million to USD$5.85 million (indexed to inflation after 2021).

A final note

Finally, here are some general points to keep in mind when planning for the transfer of your U.S. vacation property:

- Taxes may apply in both Canada and the U.S. and may be substantial.
- You should consult with Canadian and U.S. tax and legal advisors about taxes that could apply on your U.S. vacation property, as well as any strategies that may help to reduce or eliminate taxes. It is best to undertake planning prior to the purchase of the property, since it can be difficult to do any planning after the purchase of the property without triggering taxes.
- Even with the best of planning, factors that are out of your control, including currency fluctuations and legislative changes (such as those proposed by President Biden), can affect the amount of taxes that you will pay.

Although this report has explored some of the primary Canadian and U.S. tax considerations for transferring U.S. real estate, it is not comprehensive. Since the issues are complex, you should consult with Canadian and U.S. tax and legal advisors to determine the implications, and potential strategies for making ownership of your U.S. vacation home a little less taxing.

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[11] H.R.5376 - Build Back Better Act, introduced in the U.S. House of Representatives on September 27, 2021

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