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US 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 a soft US real estate market makes acquiring and holding US vacation property a reality for many Canadians. But, before you sign on that dotted line, there are US federal and state taxes that must be considered and planned for in conjunction with Canadian tax laws.

A Canadian who owns a US vacation property will be subject to US income taxes on sale and US estate taxes on death. However, with proper planning these taxes can be minimized, structured to maximize Canadian foreign tax credits, or even possibly eliminated. US income tax is payable on sale of a US vacation property held personally at generally 15% federally and, depending on which State the property is in, 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 US taxes paid or payable equal to the Canadian tax otherwise owing.

US Estate Tax

US 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-US persons, the amount of gross estate subject to US estate tax includes US real property, stocks of US companies, any debt obligations of US persons and an interest in a US trust. Under the US 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 US 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 US assets to worldwide assets. The estate of a Canadian decedent whose US 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 US estate tax. Such plans may include the use of debt, donations, life insurance, trusts and/or spousal ownership.

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Structures for purchase of US vacation property

■ Direct ownership

Direct individual ownership of US real property may be appropriate for a Canadian who is relatively young and healthy without significant personal assets and whose US estate tax liability is comparatively small. The estimated US 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 US 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.

■ Ownership through a trust

A properly structured irrevocable Canadian discretionary trust can eliminate US estate tax liability on a US 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 US 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 US 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 US vacation property

Many Canadians already own US vacation property and may not have sought tax advice in advance of their purchase and may be caught with potentially large and unintended US 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 US 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 US vacation property intended 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 the 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 US vacation property, US 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-US 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, US gift taxes are not creditable for Canadian purposes, possibly resulting in double taxation. ♦

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Federal Government Moves To Tighten Mortgage Lending Practices



over the past few years, the marketplace has experienced what the federal government has termed, perhaps euphemistically, “a period of accelerated financial innovation”. Some of those innovations included the availability of mortgages amortized over a 40-year period (meaning that borrowers might well carry a mortgage right into their retirement years) and higher loan-to-value ratios (effectively allowing purchasers, in some cases, to borrow the entire cost of the home while making no down payment at all).

In Canada, the law requires federally regulated lenders (which would include all of the major banks) to obtain mortgage insurance on loans where the down payment is less than 20% of the purchase price. That mortgage is usually obtained through a federal government agency, the Canada Mortgage and Housing Corporation (CMHC). The federal government also backs private mortgage insurers through guarantee agreements that protect lenders from any default by those private mortgage insurers. Overall, the Canadian government has a lot of exposure in the event of widespread mortgage defaults.

Perhaps with that in mind, the federal government has announced that new rules will apply to all government-backed mortgage insurance policies (whether issued by CMHC or by private insurers) issued after October 15, 2008, in respect of residential properties. The new rules touch on four areas of apparent concern, as follows:

■ Loan-to-value ratio

As noted above, it’s currently possible to get a “no money down” mortgage in Canada, and it’s also possible to get government-backed mortgage insurance on such a loan. Effective October 15, such insurance will be available only on up to 95% of the purchase price of a home. In other words, borrowers will have to come up with a minimum 5% down payment. While they may borrow that 5% from other sources, those funds won’t be insured.

THE ONGOING REPORTS OF WIDESPREAD MORTGAGE DEFAULTS and the resulting foreclosures, and even bankruptcies, occurring in the US over the past year have served as a sobering reminder of what can happen when lenders get in over their heads, whether through dubious lending practices or other factors. For a variety of reasons, including historically more conservative lending practices, Canada has been spared a similar debacle in our financial and housing markets. Notwithstanding this, the federal government, perhaps operating on the “ounce of prevention” theory, has moved to tighten up what it perceives to be potential weaknesses in Canadian mortgage-lending practices.

Traditionally, Canadian home buyers scraped together as much money as possible for a down payment, usually at least 10% of the home’s purchase price, and took out a mortgage amortized over a 25-year period. However,

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■ Amortization period

The maximum amortization period for mortgages covered by government-backed mortgage insurance will be reduced from 40 years to 35 years.

■ Credit score

A credit check is a standard part of any loan application process, and credit-worthiness is usually determined by looking at a borrower's credit score. Also effective October 15, new rules will require that borrowers seeking to obtain a mortgage for which government-backed mortgage insurance is needed have a credit score of at least 620. Recognizing that some credit-worthy borrowers might have scores that fall below that threshold, the government has indicated that there will be a limited "basket" to provide for exceptions.

■ Loan documentation

Minimum loan documentation standards will be put in place to ensure that reliable evidence exists with respect to both property valuation and the sources and amount of the borrower's income.

No government-backed insurance will be available on high-ratio (more than 80% of the property value) mortgages for which no principal payments are required during the first few years of the mortgage. This includes mortgages that begin with "interest-only" payments and home equity lines of credit. Finally, the total debt-service ratio for borrowers – that is, the percentage of gross income that is spent on debt-service payments – will be limited to 45%.

The government press release and backgrounder announcing these changes, which are available at www.fin.gc.ca/news08/08-051e.html and www.fin.gc.ca/news08/data/08-51_1e.html, respectively, emphasized that Canadian lending practices have been, on the whole, both prudent and cautious. That approach, together with the Canadian supervisory regime, has been instrumental in allowing Canada to maintain a strong mortgage market. These moves by the federal government are clearly aimed at ensuring that some of the more dubious lending practices that have contributed significantly to the current credit and housing woes in the US will not have an opportunity to creep into the Canadian mortgage and housing markets. ♦



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