REFERENCE GUIDE

Owning Residential Property In The US

Canada - US Cross-Border Tax Issues for Canadians

July 2011

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Canadians who own (or plan to acquire) residential property situated in the United States should be aware of the US and Canadian tax issues that can arise in these circumstances.

This reference guide highlights some of the important tax concerns and outlines some planning strategies that may be considered.

Please note:

- This reference guide is intended for Canadian individuals and couples who are not US citizens, Green Card holders, or certain former US citizens and long term Green Card holders who expatriated after 2000 and before June 17, 2008 under an older version of the US expatriation rules. US citizens, Green Card holders and such US expatriate persons are subject to very different rules and should consult with qualified cross-border legal and accounting advisors regarding their situation.
- This reference guide deals only with personal-use residential real estate in the US owned by Canadian individuals. It does not deal with other US real estate owned for business or commercial purposes.
- This reference guide deals only with applicable US federal income tax laws in a general manner. It does not deal with state and local income or estate taxes which may also be applicable in certain circumstances.
- For more specific advice relating to your situation, you should consult with qualified cross-border tax professionals.

The following topics are covered in this reference guide:

- US federal tax issues
  - US income tax issues
    - Rental income from US residential real estate
    - Selling your US residential real estate
  - US estate tax
  - US gift tax and US generation skipping transfer tax
- Canadian tax issues
  - Canadian income tax issues
    - Rental income from US residential real estate

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  - Selling your US residential real estate

- Acquiring residential real estate in the US

Us federal tax issues

US INCOME TAX

Rental income from US residential real estate

If you are a Canadian resident and you own or have an interest in residential real estate in the US, such as a home or condominium, that you rent out to others for all or part of the year, you will be subject to US income tax on the rental income you receive.

This rental income can be dealt with in one of two ways:

- Unless the election described below is made, the rental income is subject to US federal income tax at 30%, with no deductions for expenses. In this case, your tenant in the US must withhold 30% of the rent over the course of the year and remit this amount to the Internal Revenue Service (the IRS); or

- You can elect to treat the income as income that is effectively connected with the conduct of a US trade or business. This election is only for the purposes of dealing with your income from US real property and would not otherwise result in you being considered to be a non-resident engaged in a trade or business in the US unless there are other circumstances that would lead to this result.

  To make this election, you would file a non-resident US tax return (IRS Form 1040NR) along with certain required information. You would then be permitted to deduct expenses you incurred in connection with the rental property during the rental period, so that you would only pay US tax on the net rental income at the regular graduated rates applicable in the US.

  Deductible expenses would include mortgage interest, property taxes, insurance and maintenance costs. Depreciation must also be claimed (unlike in Canada, where it is optional). Furthermore, the amount depreciated will reduce the cost base of the property for US tax purposes. As a result, the gain on the property on a future sale will be correspondingly greater.

  It is important to note that once this election is made, it will apply to all income from all real property you own in the US (or may have an interest in) that is held to produce income. The election is also permanent and can only be revoked for future tax years in limited circumstances and only if the IRS approves.

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If the election is made, your tenant would no longer be required to withhold and remit 30% of the rent for US taxes.

Selling your US real estate

When an individual who is not resident in the US under US rules disposes of a US real property interest, the following US income tax issues arise:

- 10% withholding tax,
- US income taxes payable on the gain, and
- The need for an Individual Taxpayer Identification Number (ITIN).

Each of these is discussed below.

10% withholding tax

If you are a Canadian resident and you dispose of real estate located in the US (or any interest in US real property), the person who acquires your interest in the property must generally withhold tax in the amount of 10% of the sale proceeds and remit the amount withheld to the IRS, as stipulated under the US Foreign Investment in Real Property Tax Act (commonly referred to as FIRPTA).

If the sale results in a gain, the tax withheld can be applied towards the US income tax payable by you on the gain. If the amount withheld is greater than your US income tax liability, the difference is refunded to you when you file a US income tax return to report the gain, as outlined below.

There are some exceptions to the withholding requirement, such as the following:

- If an individual is purchasing your US real property for use as a home and the sale price is US$300,000 or less, withholding tax is not required. For this exception to apply, the buyer, or a member of the buyer's family, must have definite plans to live in the property for at least half the time the property is used during each of the first two years following the transfer. Vacant days do not count in this calculation.
- The withholding requirement may be waived or reduced if the IRS has issued a withholding certificate to that effect. Either the purchaser or the seller can apply for a withholding certificate, which would be issued if the circumstances meet one of several recognized categories under the FIRPTA rules.

  For example, where your US income tax liability on the sale of your US real property is expected to be less than 10% of the sale price, you can apply for a withholding certificate to allow for a reduced amount to be withheld, rather than the full 10%.

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Similarly, if the sale price is being paid to you in installments, you can apply for a withholding certificate to allow for the withholding tax to be paid as the installment payments are made. Otherwise, the buyer will have to withhold 10% of the full sale price at the time of closing.

The application for a withholding certificate should be made prior to the closing date of the sale.

If you are selling the US property near the end of the calendar year and the entire sales proceeds are to be paid at that time, it may actually be more expedient to not go through the process of requesting a withholding certificate. Instead, you could simply allow the gross 10% FIRPTA tax to apply and file a 1040NR return (as discussed below), early in the subsequent year to receive a tax refund of any excess tax withheld.

Note that some states may also have withholding tax requirements that parallel the federal US requirements under FIRPTA.

US income taxes on the gain

As a non-resident of the US, you must file a US 1040NR income tax return when you dispose of an interest in US real property.

A disposition includes an outright sale, as well as gifts, exchanges of real property interests, or any other transfer, including a distribution to shareholders of a corporation or to beneficiaries of a trust or estate.

The US taxes the full amount of the gain on the sale of US real property. Regular graduated US tax rates apply for property held for less than one year, while a reduced rate applies for property held for longer than one year. This reduced long-term gain rate is scheduled to increase in 2013, barring any future legislative changes.

Note that state tax may also be payable on the gain.

Note also that the Canada-US Income Tax Convention (the Treaty) includes a limited opportunity for a Canadian resident to reduce the amount of a gain taxable in the US on the sale of US real property. Specifically, a Canadian resident who owned a non-business US real property interest on September 26, 1980, or who acquired such an interest from another Canadian resident in a non-taxable transaction, will only be taxed on the portion of the gain accruing since January 1, 1985. If applicable, you must claim the Treaty benefit on your US tax return and must provide certain specific information.

The need for an individual taxpayer identification number

For US tax reporting and withholding purposes, you will need an ITIN. This is issued by the IRS to individuals who are not eligible for and do not have a US Social Security Number.

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An ITIN is required before you can file a US income tax return, whether to report US source income or gains on the sale of US real property or to claim credit for US withholding tax. It is also required if you will be applying for a withholding certificate. Even when a withholding certificate will not be used, it is preferable to have an ITIN to more clearly tie the withheld taxes to you.

Because the process to obtain an ITIN can be challenging, it is recommended that the application be made well before the ITIN will be required. Professional assistance may also be needed.

US ESTATE TAX

Canadians who die owning US situs property – that is, property that is considered to be situated in the US under US rules – may be subject to US estate tax on death.

Our reference guide on US estate tax outlines what constitutes US situs property and highlights how and when US estate tax may apply to the estate of a Canadian, as well as some possible strategies that may be available to minimize US estate tax.

US GIFT TAX AND US GENERATION SKIPPING TRANSFER TAX

It is possible that US gift tax and/or US generation skipping transfer tax could apply in certain circumstances. For example, if you make a gift of US real estate, this would trigger not only Canadian tax on one-half of the gain, but would also give rise to US gift tax if the value of the gift exceeds the annual exemption of US$13,000. In addition, depending on the recipient of the gift, generation skipping transfer tax could also apply.

Note that there is no foreign tax credit available in Canada for the amount of US gift tax or generation skipping transfer tax paid.

Professional advice should be obtained if you may be considering gifting US situs property.

Canadian tax issues

CANADIAN INCOME TAX ISSUES

Rental income from US residential real estate

If you receive rental income from residential real estate in the US, such as a home or condominium that you rent out to others for all or part of the year, you must report that income in your Canadian income tax return for the year. The income must be reported in Canadian dollars.

If you paid US taxes on the rental income, you may be able to claim a federal foreign tax credit in your Canadian income tax return for the amount of US taxes you had paid.

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Selling your US real estate

Canadian tax also arises when you sell your US real estate for more than its cost. Unlike the US, which taxes 100% of the gain, only one half of the gain is taxable in Canada. However, if the principal residence exemption, described below, is available, it could eliminate Canadian taxes on the sale of your US real property.

Note that in preparing your Canadian tax return to report your gain on the sale of your US real estate, you may be able to claim a tax credit in Canada for the amount of the US tax you had paid on the sale. If, however, you use the principal residence exemption, the amount of this foreign tax credit could be reduced. This is explained further below.

Principal residence exemption

Under Canadian income tax laws, the principal residence exemption may eliminate Canadian income tax on capital gains arising on a sale, or deemed sale at death, of a qualifying residence.

Because of the broad definition of principal residence, this exemption can apply not just to a home, but also to other qualifying properties, including even a home or vacation property outside of Canada.

In order for a property to qualify as your principal residence for the purposes of the exemption, it must meet the following requirements:

- The property must be owned by you.
- The property must be ordinarily inhabited by you or by your spouse, common-law partner or child or by your former spouse or common-law partner. A property such as a seasonal residence that is only used by you or by a qualifying family member for a part of a year, such as during a vacation period, can still qualify.
- Your main purpose for owning the property must not be to earn income. In certain situations, incidental rental income from a seasonal residence should not disqualify the property. However, claiming capital cost allowance on a property for Canadian income tax purposes will disqualify the property from the exemption, according to CRA administrative policy.

If you have more than one property that satisfies the above criteria, some planning may be necessary in order to take maximum advantage of the exemption in your circumstances, since after 1981, an individual (or a family unit) can only have one property qualify as a principal residence at any one time.

Accordingly, when you are selling one of your qualifying properties, or if there is a deemed sale on your death, you (or your executors, as the case may be) will need to carefully review a number of factors to determine which property should be designated as your principal residence

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and for what period(s) of time. Such factors would include the cost, value and acquisition date of each qualifying property, as well as whether you had claimed the exemption for any other property for any of the relevant years.

Another consideration is the effect that claiming the principal residence exemption can have on the foreign tax credit available to you when you dispose of your US property.

The foreign tax credit is a mechanism under Canadian tax law designed to minimize double tax where income, including proceeds of sale, is subject to both US and Canadian income tax. The foreign tax credit generally provides a credit for the amount of US income tax paid, and this credit can be used to offset Canadian tax otherwise payable on the income (assuming that Canadian tax levels exceed those of the US). This would be relevant to you in the event you sell, or, on your death, are deemed to sell, US property, since both Canadian and US income tax (and US estate tax, in the event of your death) will apply at that time.

Note, however, that claiming the principal residence exemption on US real property for Canadian tax purposes could affect your ability to fully take advantage of the foreign tax credit for US income tax or estate taxes paid.

In the end your decision with respect to the principal residence exemption would depend on several factors, including:

- the relative values of, and levels of accrued gains on, your qualifying properties in Canada and the US, and
- prevailing Canadian and US tax rates applicable to capital gains when you dispose of one of your qualifying properties in Canada or the US.

Because these factors will change from year to year, assessing whether to claim the principal residence exemption on a sale must, ultimately, be undertaken around the time that a proposed sale transaction or deemed disposition takes place.

Acquiring residential real estate in the US

If you are planning to acquire residential real estate in the US primarily for personal use, it is important to consider the possible ownership options as well as the Canadian and US tax and other implications of each of these options.

There are various ways to acquire or hold residential real estate in the US. Some of these options include:

- Individual ownership – With this option, you would own the property personally.
- Joint ownership – With this option, you would own the property jointly with one or more others.

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- Ownership through a Canadian trust - Typically, the trust would be discretionary and would be for the benefit of several family members.
- Shared ownership among family members – In this situation, spouses, or several family members, would each acquire an undivided interest in a US residential property.
- Split interest purchase - With this option, the parent(s), for example, might acquire a life interest in the US property, with the children acquiring the remainder interest. In this case, the child should use their own funds or funds acquired from someone other than their parents.
- Partnership of family members – Under this option, family members might use a general or limited partnership to acquire US residential real estate, with each of the partners contributing a proportionate share of the purchase price.
- Ownership through a Canadian corporation – This was once considered an effective way to acquire US residential real estate provided certain stringent requirements were met. However, due to changes in CRA's administrative policy effective in 2005, the use of a Canadian single-purpose corporation to hold US personal use real property (such as a home, condominium or other similar property) is no longer recommended.

Other possible ownership options might include:

- a US Company,
- a Limited Liability Company,
- a partnership treated as a foreign corporation for US tax purposes, or
- a partnership not treated as a foreign corporation for US tax purposes.

In the end, the choice will depend on your personal circumstances and intentions, as well the tax and other implications in Canada and the US at the relevant time. It would therefore be imperative to obtain advice from qualified cross-border tax professionals when you are considering acquiring US residential property.

Planning for existing residential real estate in the US

To avoid unintended tax consequences, cross-border tax professionals should also be consulted before changing ownership of US real estate.

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Conclusion

There are many complex issues and options to consider when dealing with the interaction of Canadian and US taxation with respect to the ownership of residential property in the US.

Accordingly, we recommend that you obtain advice from qualified cross-border tax advisors to ensure that you optimize your Canadian and US tax situation.

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