

# THE NAVIGATOR



## CANADIAN OWNERS RENTING OR SELLING U.S. REAL ESTATE

### Understand the key tax issues and potential strategies to minimize taxes payable

Each year, many Canadian snowbirds escape the long and cold winter by flocking to popular warm climate destinations in the U.S. such as Florida and Arizona. While some snowbirds choose to rent their vacation or retirement home in the south, others choose to purchase their own U.S. real estate property. Purchasing your own property has its advantages; however you may be surprised by the numerous tax requirements and other considerations that can substantially increase the complexity of owning real estate in the U.S.

This article will discuss the U.S. tax implications for Canadian owners renting or selling their U.S. real estate and will highlight key estate planning considerations. It will address questions such as:

- What are my tax obligations if I rent or sell my U.S. property?
- Do I need to file a U.S. income tax return?
- Will I be subject to double tax?
- Are there any strategies available to minimize tax?
- What are the tax implications on my death?
- Is my Canadian Will and Power of Attorney adequate to cover my U.S. real estate property?

The information provided is based on direct U.S. real estate ownership by Canadian individuals who are not U.S. citizens, green-card holders or residents and who are not engaged in a U.S. trade or business. While some of the information may also apply to real estate ownership through a partnership, trust or corporation, this article was not written to address all the considerations for ownership in these structures.

*This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified cross-border tax advisor before acting on any of the information in this article.*



RBC Wealth Management



You can elect to file a U.S. non-resident income tax return (Form 1040 NR) and pay tax on a “net rental basis” without being subject to withholding tax.

## **TAX ON RENTAL INCOME FROM YOUR U.S. PROPERTY**

A Canadian resident earning rental income from U.S. real estate must comply with U.S. income tax laws and reporting requirements. A Canadian may choose one of the following two options under U.S. tax laws:

### **OPTION #1 – PAY 30% WITHHOLDING TAX ON GROSS RENTS, NO REQUIREMENT TO FILE U.S. TAX RETURN**

You can choose to have the gross rental income you earn taxed at a flat 30% U.S. withholding tax and not have to file a U.S. income tax return. This option is simple and you avoid the cost of preparing a U.S. income tax return. However, if you choose this option, you cannot deduct any rental expenses in determining your U.S. tax obligation. Since this option generally results in a higher overall cost than option #2 it may not be the most appropriate option economically.

Also, while you do not have to file a U.S. income tax return, you will still need to file a Canadian return. For Canadian tax purposes, regardless of whether you choose option #1 or #2 you are subject to Canadian tax on the net rental income. You will need to report the gross rental income and related ordinary expenses on your Canadian income tax return. You can claim a foreign tax credit for the U.S. tax you paid to reduce or eliminate double taxation. It is possible that the foreign tax credit will not allow you to recoup the full 30% U.S. withholding tax paid.

### **OPTION #2 – FILE U.S. NON-RESIDENT TAX RETURN TO PAY TAX ON NET RENTAL BASIS**

Alternatively, you can elect to file a U.S. non-resident income tax return (Form 1040 NR) and pay tax on a “net rental basis” without being subject

to withholding tax. This election to file annually is a permanent election and can only be revoked in limited circumstances.

Similar to the Canadian rules, you can deduct expenses such as property taxes, mortgage interest, insurance, management fees and utilities to determine your net rental income. U.S. tax laws also impose a mandatory deduction for depreciation. There are special rules regarding the ability to claim rental losses. Those losses that cannot be claimed in the current year can be carried forward and potentially used to offset rental income in future years and capital gains if the property is sold.

The benefit under this option is that your net rental income amount is subject to U.S. tax at your marginal tax rate, which will likely be substantially lower than the amount of withholding tax you would otherwise have to pay. As in option #1, you must report the net rental income on your Canadian tax return. You will be able to claim a foreign tax credit which will likely be sufficient to recoup all of the U.S. tax paid thus eliminating double tax. This option may result in a lower overall cost than option #1 even if you must pay tax return preparation fees.

### **NET RENTAL BASIS – U.S. TAX FORMS AND DEADLINE**

If you elect to file on a net rental basis you are required to complete Form W-8ECI - *Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*. You should submit this form to your tenant or to a U.S. agent, not to the Internal Revenue Service (IRS).

You are also required to file a U.S.

The purchaser of your property is obligated to act as a withholding agent for the IRS.

non-resident tax return that includes completing and attaching Schedule E – *Supplemental Income and Loss*. The U.S. return must be filed even if the net rental calculation results in a rental loss.

**The tax return filing due date is June 15 of the following year; however, regardless of the filing deadline any balance of tax owing must be paid to the IRS by April 15th of the following year to avoid late interest charges.**

If you miss the June 15 deadline, then there is an additional 16-month grace period to file a return on a net rental basis. Beyond the 16-month grace period, you will no longer be eligible to elect to pay on a net rental basis and the 30% withholding tax on gross rental income (plus any penalties and interest) will apply for that tax year. If you hold the property jointly, you and each other joint owner will need to file a separate tax return to report your proportionate share of rental income and expenses.

### **TAX ON SALE OF YOUR U.S. PROPERTY**

As a Canadian resident, if you sell your U.S. real estate property, the following U.S. tax rules will apply to you:

- i) The gross sale proceeds will be subject to a 10% U.S. withholding tax at the time of transfer; and

- ii) You will need to file a U.S. non-resident income tax return and pay tax on the capital gain.

The purchaser of your property is obligated to act as a withholding agent for the IRS. They must file IRS Form 8288 – *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* and are required to withhold and remit withholding tax on the amount you will receive on the sale of property unless an exception to the withholding tax requirement applies, discussed below. The purchaser must also complete IRS Form 8288-A – *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, for each person for whom tax must be withheld and attach it to Form 8288. The purchaser is not required to provide the seller with a copy of Form 8288-A since the IRS must approve and stamp it first and will then provide it to the seller. The seller will use the form to claim the withholding tax remitted on the U.S. non-resident tax return that they are required to file. The purchaser is required to file these forms with the IRS by the 20th day after the date of transfer.

### **10% WITHHOLDING TAX ON THE PROCEEDS OF SALE**

If you meet the following two exceptions, you may be able to reduce or waive the 10% withholding tax:



As a resident of Canada, you will also be required to report the sale on your Canadian tax return.

**EXCEPTION 1: SALE PRICE IS US\$300,000 OR LESS**

If you sell your U.S. real property for US\$300,000 or less and the purchaser intends to use the property as a principal residence, then the 10% withholding tax requirement will not apply. No form or documentation is required to be filed by the purchaser with IRS Form 8288 to declare the property as a principal residence.

**EXCEPTION 2: SALE PRICE IS GREATER THAN US\$300,000 – WITHHOLDING CERTIFICATE**

If the proceeds are greater than US\$300,000 and you expect your tax liability on the gain to be less than 10% of the gross sale price, you can request for a reduction or elimination of the withholding tax requirement by filing IRS Form 8288-B – *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*. You must complete this form before the closing date of the sale. If the IRS grants your application, the certificate will indicate the amount of tax that should be withheld by the purchaser instead of the full 10%.

**U.S. NON-RESIDENT TAX RETURN TO REPORT THE SALE**

You will need to file a U.S. non-resident income tax return (Form 1040NR) to report the sale of your U.S. real estate. You may realize a capital gain/loss or recapture (the treatment of all or a part of the gain as ordinary income). If you were subject to withholding tax, the amount withheld will reduce the amount of taxes you have to pay to the IRS.

As a resident of Canada, you will also be required to report the sale on your Canadian tax return. You can claim a foreign tax credit for the U.S. income tax you paid. This will eliminate or minimize double taxation.

**CALCULATING THE U.S. CAPITAL GAIN/LOSS AND RECAPTURE ON THE SALE**

The capital gain/loss you report on the sale of U.S. real estate that you use as a vacation property is calculated by taking the difference between your net proceeds and your adjusted cost base (ACB) of the property. The ACB is generally the total purchase price plus the cost of improvements.

If the property is a rental property, you must also deduct the mandatory depreciation (whether or not you actually claimed it) in order to determine the ACB. You will need to report a portion of the sale proceeds, up to the amount of depreciation claimed, as “depreciation recapture” or an “un-recaptured section 1250 gain” on your U.S. tax return. The remaining balance of your sale proceeds is reported as a capital gain. Any unused capital losses carried over may be used to offset the capital gain.

Speak to your professional cross-border tax advisor for more information regarding the amounts you should report on your U.S. tax return.

**MAXIMUM U.S. CAPITAL GAINS TAX RATE: 12-MONTH RULE**

If the property is held for longer than 12-months prior to its disposition a preferential U.S. tax rate applies to the capital gain. The maximum tax rate on long-term U.S. capital gains based on the preferential tax rates is 15% to 20% of the capital gain depending on your income level. If the U.S. property is held for under 12 months then regular U.S. graduated tax rates, which apply to ordinary income, will apply to the capital gain. There may also be a U.S. state tax liability to consider. For rental property, depreciation recapture and un-recaptured section 1250 gains do not qualify for the preferential capital gains

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tax rates. Depreciation recapture is taxed like ordinary income and un-recaptured section 1250 gains are subject to a maximum U.S. tax rate of 25%.

#### **PRINCIPAL RESIDENCE EXEMPTION**

For Canadian tax purposes, if the U.S. property qualifies as a principal residence, you can shelter the entire amount of the gain by claiming the principal residence exemption. However, if you decide to use this exemption, you cannot claim a foreign tax credit on your Canadian return to recoup the U.S. income tax paid unless you are reporting other U.S. source income and have a sufficient Canadian tax liability.

For U.S. tax purposes, there are rules that will exclude all or a portion of the gain on the sale of property that qualifies as a home. However, the U.S. tax rules have different criteria than Canada that must be met in order for the home to qualify. It may be difficult for many Canadians to claim the exclusion for U.S. tax purposes since a principal residence for U.S. tax purposes must generally be the home you use the most. Speak to your cross-border tax advisor for more information regarding this exemption.

#### **OTHER INCOME TAX CONSIDERATIONS**

##### **REQUIREMENT FOR INDIVIDUAL TAXPAYER IDENTIFICATION NUMBER (ITIN)**

In order to file a U.S. non-resident income tax return (whether to report rental income on the net rental basis or to report the sale of U.S. property) you will be required to supply your ITIN. If you do not already have one, you can apply for one using IRS Form W-7 - *Application for IRS Individual Taxpayer Identification Number*.

##### **TRACKING THE TIME SPENT IN THE U.S.**

Whether you own a property in the U.S. or not, if you travel to the U.S. frequently, your physical presence in the U.S. may create U.S. income tax filing obligations including the requirement to file a U.S. income tax return and other disclosures. This topic is discussed in greater detail in a separate RBC article. Ask your RBC advisor for a copy of our article that discusses U.S. residency for more information.

##### **CANADIAN FOREIGN INCOME VERIFICATION REPORTING**

Snowbirds with U.S. vacation property used to earn rental income should consider foreign reporting rules under Canadian tax laws. With these rules, Canadians who hold certain types of foreign property with a cost in excess of C\$100,000 at any time during the



U.S. vacation properties that are “primarily” held for personal-use are categorized as personal-use property and are exempt from reporting under the T1135 foreign reporting rules.

taxation year are required to disclose certain information related to the foreign property on Form T1135 – *Foreign Income Verification Statement*.

U.S. vacation properties that are “primarily” held for personal-use are categorized as personal-use property and are exempt from reporting under the T1135 foreign reporting rules. The Canadian tax authorities generally consider “primarily” to mean more than 50%. Generally, a U.S. vacation property that is not rented out or is only rented for a small portion of the year in order to recover some expenses with no real profit motive would be considered personal-use property and exempt from T1135 reporting. However, if the U.S. vacation property is used primarily as a rental unit with the view to earn profits, for example, the property is rented out for eight out of twelve months at market rates, the property will not qualify under the personal-use exemption. The property must be reported on T1135 even though you personally used the property for four months.

### **ESTATE PLANNING CONSIDERATIONS U.S. ESTATE & GIFT TAX**

If you die owning “U.S. situs assets” such as stock of a U.S. corporation or U.S. real estate then you may be subject to U.S. estate tax. There are several strategies that Canadians may consider to minimize their exposure to U.S. estate tax. These include gifting or selling U.S. situs assets prior to death, holding property in a properly structured Canadian trust, Canadian partnership or Canadian corporation, or acquiring life insurance to cover the potential U.S. estate tax liability. Canadians may also be subject to U.S. gift tax when they gift “U.S. tangible property” such as U.S. real estate,

jewellery, cars, and artwork that is located in the U.S.

For additional information on U.S. estate and gift taxes and on strategies to minimize your exposure, please ask your RBC advisor for a copy of our article U.S. Estate Tax for Canadians. There is also a separate article, U.S. Estate Tax: Canadians Owning U.S. Real Estate, which explores U.S. estate tax exposure related to owning U.S. real estate.

### **YOUR WILL**

It is important to ensure that you have a valid Will that properly addresses your wishes with respect to your U.S. real estate. Although a Canadian Will may be adequate, complexities may arise due to potential clashes between the differing Canadian and U.S. succession laws. To minimize this risk, you should consider executing a separate Will (drafted in the U.S. state where the U.S. real estate is located) to deal specifically with your real estate and other assets located outside Canada. When executing a separate U.S. Will, it is important to ensure that it does not conflict or revoke your Canadian Will. Speak to a cross-border legal advisor regarding multiple Wills.

### **YOUR POWER OF ATTORNEY**

Consider preparing a properly drafted power of attorney that addresses your U.S. real estate. This will ensure that your property continues to be managed in accordance with your wishes (particularly important in the case of a rental property) in the event of your incapacity/disability. Under common law, the law of the jurisdiction in which the power of attorney is executed usually governs the relationship between a donor and the attorney. Therefore, it is important to execute a separate power of attorney in the U.S.

It is important to execute a separate power of attorney in the U.S. state where your real estate and other U.S. assets are located.

state where your real estate and other U.S. assets are located. Speak to a cross-border legal advisor for advice.

**BE PREPARED**

Whether you already own U.S. real estate or are considering making a purchase there are significant tax

planning, financial planning and estate planning implications to consider. It is important to familiarize yourself with these issues so you know what to expect and how to prepare. Speak to your RBC advisor and your cross-border tax and legal advisors for advice.

Please contact us for more information about the topics discussed in this article.

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