The Navigator

RBC WEALTH MANAGEMENT SERVICES

Owning and Renting Property in the US

Each year, many retired individuals escape from the long and cold Canadian winters by flocking to popular warm climate destinations in the U.S such as Florida and Arizona. While some Canadian snowbirds choose to rent their vacation or retirement home in the south, others choose to purchase their own condo or other U.S. real estate property. Though owning your own U.S. vacation or retirement property may have its advantages, you may be surprised when you factor in the numerous tax requirements and other considerations that can substantially increase the complexity of owning a home in the U.S. Those additional issues may include U.S. tax on rental income, potential U.S. withholding taxes should you sell your real estate property and U.S. Estate Taxes upon death. Additionally, it is important to be aware of your potential dual tax filing requirement that may require you to file both a Canadian and a U.S. tax return (even for taxation years for which there is no tax payable in the U.S.). While foreign tax credits are available to reduce or eliminate potential double taxation, it is not always possible to avoid any incremental taxation.

Whether you are a Canadian resident who either already owns real estate property in the U.S., or if you are contemplating such a purchase, this article is intended to raise your awareness of key U.S. tax implications and other considerations by addressing questions such as: What are my tax obligations on renting/selling U.S. real estate property? What are the tax implications on death? Are there any strategies available to minimize tax? Is my Canadian Will and Power of Attorney adequate to cover my U.S. real estate property?

This article will assume that you are not a U.S. citizen or green card holder.

Taxation of Rental Property Income

Even though you are a Canadian citizen and resident, you are subject to U.S. income tax on any rental income you receive from your U.S. real estate property. To comply with this Internal Revenue Service (IRS) tax reporting requirement, you can choose one of the following two options:

Option #1: 30% Withholding Tax on Gross Rents

You can choose to have your gross rental income taxed at a flat 30%, but this option *does not permit for deduction of any expenses*. In many cases, this can be a very expensive option. Under this option, you do not have to file a U.S. tax return to report this rental income. However, you will still need to report the net rental income on a Canadian tax return. Foreign tax credits can be taken to eliminate double taxation, but it is possible that the full 30% U.S. withholding tax will not be recouped.

Option #2: Net Rental Basis

Alternatively, you can elect to file a U.S. non-resident income tax return (Form 1040 NR) on a *"net" rental income* basis and complete Schedule E. Net rental income is defined as gross rents less ordinary and usual expenses including property taxes, mortgage interest, insurance, management fees, utilities, etc. It must also be noted that, unlike in Canada, U.S. tax laws impose a *mandatory* deduction for *depreciation* for U.S. tax filing purposes. The benefit under this option is that your net rental income amount subject to U.S. tax at your marginal tax rate will likely be substantially lower than the gross rental income amount subject to the 30% withholding tax. If electing to file on a net rental basis, then you will need to complete Form W-8ECI to avoid the 30% U.S. withholding tax. Form W-8ECI needs to be submitted to your tenant or to a U.S. agent (not to the IRS).

Net Rental Basis – Tax Forms Required and Deadline

If you choose to be taxed based on the net rental basis option, then you will have to file a U.S. tax return and Schedule E **by June 15 of the following year even if the net rental calculation results in a rental loss. 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 the June 15 deadline is missed, 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. For jointly held properties, each party is required to file a separate tax return and report their proportion of the rental income and expenses.

In addition to your U.S. tax filing obligations, you will also need to report on your Canadian tax return in Canadian dollars the net U.S. rental income/loss based on Canadian tax rules. In most cases, foreign tax credits taken on the Canadian tax return will alleviate potential double taxation issues.

Taxation on the Sale of U.S. Real Property

Calculating Taxable Capital Gain/Loss

Should you sell your U.S. real estate, you will be required to file a U.S. tax return to report any capital gain/loss on the disposition and to pay U.S. capital gains tax on any profit. You will also be required to report this capital gain/loss on your Canadian tax return (as discussed above, foreign tax credits may offset or minimize any double taxation issue). Your taxable gain will be determined by the difference between your net proceeds and your original cost base. This cost for U.S. tax purposes is referred to in the U.S. as your "adjusted basis" which is generally calculated as your total purchase price plus the cost of improvements less mandatory depreciation deductions (if you fail to deduct appropriate depreciation, the IRS will generally reduce the adjusted basis as if you had claimed it).

Maximum Capital Gains Tax Rate: 12-Month Rule

If you held your property for longer than 12-months prior to disposition, then the current maximum capital gains rate that you may be subject to in the U.S. is 15% (for 2012). Alternatively, if you held your property for under 12 months, then regular graduated tax rates will apply to any resulting taxable capital gain. Currently, the highest tax rate for U.S. federal tax purposes is 35% (2012). There may also be a U.S. state tax liability to consider. For Canadian tax purposes, the current average highest marginal tax rate on capital gains is effectively 22% (i.e. 44% divided by 2) because Canada only taxes one-half of the capital gain.

Principal Residence Exemption for Canadian Tax Purposes

If the property qualifies, you can shelter the amount of the gain taxed in Canada by claiming the principal residence exemption for Canadian tax purposes. Note that if you were to use this exemption, there is a possibility that a foreign tax credit may not be fully credited on your Canadian return unless you are reporting other U.S. source income and have sufficient Canadian tax. Similar rules for principal residences exist in the U.S.; however, with certain limits on the amount of the gain that can be excluded. It may be difficult for many Canadians to claim the exclusion for U.S. tax purposes since a principal residence for U.S. purposes must generally be the home you use the most. A discussion of these U.S. tax rules is beyond the scope of this article. You should consult with a qualified cross-border tax advisor for more details.

10% Withholding Tax

In addition to being subject to U.S. tax on any capital gains, you may also be subject to a withholding tax of 10% of the gross sale price that could potentially be applied at time of sale. If the withholding tax is applied, it can be taken as a credit on the U.S. tax return. There are two exceptions to this withholding tax requirement:

Exception 1: Sale Price is U.S. $300,000 or less

If you sell your U.S. real property for U.S. $300,000 or less, and provided that the purchaser intends to use your property as a principal residence, then the 10% withholding tax will not apply.

Exception 2: Sale Price Greater Than U.S. $300,000 - Withholding Certificate

If the proceeds are greater than $300,000 and you have an expected tax liability on the gain that is less than 10% of the gross sale price, you can potentially reduce or eliminate this withholding tax requirement by filing IRS Form 8288-B to request a Withholding Certificate. This form must be filed before the closing date of the sale. If granted, the certificate will indicate the amount of tax that should be withheld instead of the full 10%.

U.S. Residence Rules

If you are a Canadian resident who travels frequently to the United States, your physical presence in the United States may trigger an obligation requiring you to file a U.S. tax return. Please refer to our article discussing U.S. residency status for complete details on possible additional filing requirements.

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U.S. Estate Taxes

If you die owning U.S. assets such as stock of a U.S. corporation or U.S. real estate property, then you may be subject to U.S. estate tax on the fair market value of your "U.S. situs assets".

For tax year 2012, the top U.S. estate tax rate is 35% with an exemption amount of US $5.12 million.

This exemption amount may reduce or eliminate your exposure to U.S. estate tax since your exemption will now be a prorated percentage of a much higher exemption amount. However, Canadians with significant assets should still manage their U.S. estate tax exposure since the tax rate and exemption amount only apply until December 31, 2012. After 2012, the rate and exemption amount will expire. Unless further legislation is enacted, in 2013 the top U.S. estate tax rate will increase to 55% and the exemption amount will be reduced to only U.S. $1 million.

Even if your worldwide estate falls below the exemption threshold such that you avoid exposure to U.S. estate taxes, your estate representative will still be required to file a U.S. tax return on behalf of your estate if the value of your U.S. property is at least U.S. $60,000.

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Strategies to Minimize Estate Taxes

There are several strategies that you can consider to minimize your exposure to U.S. estate tax. These include gifting/selling property prior to death, holding property in a Trust, Canadian partnership or Canadian Corporation, or acquiring life insurance to cover the potential tax liability. Note that if you use the property for personal purposes, a Canadian holding company or partnership may not work. On the Canadian side, you may have a shareholder benefit. From the US point of view, they may look through the two structures and deem you to own the property personally anyways.

For additional information on U.S. Estate Taxes and on strategies to minimize your exposure, please ask your advisor for a copy of our article on U.S. estate tax for Canadians. Before implementing any of the strategies to reduce exposure to U.S. estate tax you should consult with a qualified cross-border tax advisor to ensure your individual circumstances are considered and potential tax implications are evaluated.

For example, gifting real estate located in the U.S. can trigger the U.S. gift tax for Canadian residents if the value of the gift exceeds certain minimum amounts. If the total value of all gifts to any individual is U.S. $13,000 or less (2012 value) in a given year, these gifts will not attract

U.S. gift tax. This threshold rises to U.S. $139,000 (2012 value) if the gift of tangible property is made to a spouse who is not a U.S. citizen. If you exceed these amounts you are subject to gift tax and will not able to use the U.S. $5.12 million (2012 value) lifetime gift tax exclusion since it is available only to U.S. citizens, U.S. green card holders or U.S. resident aliens who are domiciled in the U.S.

Another example that may trigger adverse tax consequences worthy of consideration is the potential U.S. and Canadian capital gains tax that may be triggered on the sale of U.S. real estate property that has appreciated in value since the original purchase date.

Estate Taxes and Foreign Tax Credits

Under the Canada-U.S. tax treaty, your executor may claim a foreign tax credit on your final Canadian tax return for U.S. Estate Tax paid. A foreign tax credit will reduce your Canadian income tax liability attributable to U.S. source income that is reported on your final Canadian income tax return by some or all of your U.S. Estate Tax liability. This could potentially minimize or entirely eliminate double taxation.

However, a foreign tax credit is generally available only when U.S. Estate Tax and Canadian income tax occur during the same year. You may not be able to claim a foreign tax credit if your U.S. source assets have not appreciated in value. This is because Canadian deemed disposition tax is imposed as a capital gains tax (on the appreciation of the asset to the date of death) while U.S. Estate Tax is based on the fair market value of the asset at the time of death. If you leave assets to a surviving spouse on a tax-free rollover basis, even if U.S. source assets have appreciated in value, there may still be no Canadian income tax incurred to claim a foreign tax credit against. This may result in double taxation.

It is very important for executors to consider these issues when making decisions affecting the deceased's final tax return filing. For example, executors should decide whether it is more advantageous for the estate to elect not to transfer U.S source assets on a tax-free rollover basis to a surviving spouse. This will allow the executor to trigger Canadian income tax in order to claim a foreign tax credit for U.S. Estate tax incurred, thereby increasing the adjusted cost basis of the assets transferred to a surviving spouse.

Executors should decide whether it is more advantageous for the estate to elect not to transfer U.S source assets on a tax-free rollover basis to a surviving spouse to trigger Canadian income tax in order to claim a foreign tax credit for U.S. Estate tax incurred, thereby increasing the adjusted cost basis of the assets transferred to a surviving spouse.

Other Considerations

International Estate Planning

It is important to ensure that you have a valid Will that properly addresses your wishes with respect to your condo or other real estate property in the U.S. Though a Canadian Will may be adequate to address your U.S. property, complexities may arise due to potential clashes between the differing Canadian and U.S. succession laws. To minimize this risk, you may wish to consider executing a separate Will (drafted in the U.S. state where the U.S. property is located) to deal specifically with your real estate property and other assets outside Canada. When executing a separate U.S. Will, it is important to ensure that it does not cause the revoking of your Canadian Will.

Power of Attorney

A properly drafted power of attorney that addresses your U.S. property will ensure that it 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. state where your real estate property and other U.S. assets are located.

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