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Life events: Buying U.S. property

Financial checklist

When new and exciting changes in your lifestyle lead you to traveling south of the border regularly, the question you may ask yourself is - should we be investing in a property in the U.S.?

If you consider renting or buying, take the opportunity to review your situation and objectives and consider asking your advisor these questions:

- Where do we plan on going?
- Will we be spending a substantial amount of time away from our home?
- Should we rent or buy?
- Will we need a real estate agent and how will we find one?
- What are our current and future needs for a property in the U.S.?
- Will our heath care plan cover our out of country travel?
- How much should we budget for buying U.S. property?
- What are the tax implications of our time away from home?
- What are the tax implications for owning or renting U.S. property
- What are our financing options for buying U.S. property?
- What are the implications of inheriting property abroad?

Who hasn't thought about buying a piece of property south of the border? But as tempting as the thought maybe there's a lot to consider.

Depending how you plan to use your property – personal-use only, rent it out or both – will go a long way to determining how you want to structure your purchase to reduce and or eliminate your tax exposure. The following looks at the various ownership structures available to Canadians and the tax implications of each.

Limited liability corporation

A Limited Liability Corporation or LLC is often recommended by Americans to Canadians as the best investment structure for people who are planning to rent or lease out their property on a regular basis. LLC's are relatively inexpensive to set up and you will be protected from personal liability in the case of a tenant, contractor or property manager accident.

This is no small point as anyone who visits or works on your property is a potential plaintiff. Americans also benefit from an LLC because they're considered 'flow-through' entities which means they pay no tax – it flows through to the property owner who declares it on their personal return. The difficulty for Canadians is that the Canadian Revenue Agency does not recognize LLCs so you'll have to pay tax twice if you rent – once in the U.S. and again in Canada.

Limited liability partnership

A better option for holding your U.S. property may be a Limited Liability Partnership or LLP. An LLP offers the same level of protection in terms of personal liability as an LLC and you won't be taxed twice. You will have to choose between an American LLP and a Canadian LLP with each having advantages and disadvantages. With a Canadian limited partnership you and the other partner(s) are taxed at your personal rates for any rental income earned and you will be subject to a withholding tax which is 30% of the rental amounts. If you choose to file the paperwork in the U.S. and create a U.S. limited partnership you will enjoy the same level of protection in terms of personal liability as the Canadian version but you won't be subject to a withholding tax. Another advantage is that it may be easier to secure financing from a U.S. lender. You may, however, have to pay estate tax on your death but you will be able to claim and apply tax credits to your Canadian return for any monies paid in the U.S.

Trust

Another way to buy U.S. property is through a trust. A trust is where property is held by one party for the benefit of another so you can pass property to your beneficiaries while you are still alive. The big attraction with a trust stems from its role in estate planning. When a spouse dies – assuming the trust is in both spouses names – the U.S. property can simply be transferred to the surviving spouse with no tax consequences. Canadians may be liable for U.S. estate taxes if they die owning U.S. real estate, though the way those taxes are calculated differs from Canadian rules that apply to the deemed disposition of assets on death. In Canada, taxes are applied to any accrued capital gains earned on vacation and investment properties that are not considered to be the owner's principal residence. In the U.S. taxes are levied based on the property's fair market value at the time of death. It's worth noting that the current U.S. federal estate tax applies to estates valued above U.S. $5.34 million. So if your total worldwide net worth is below this threshold you will be exempt from paying estate tax.

Holding property personally

The simplest ownership option is holding the property personally. This saves you the cost and administrative headaches associated with the creation of a company, partnership or trust. And if you're not earning any rental income, you won't have to worry about taxation until you sell, gift or will the property. One thing to avoid when holding property personally is joint ownership with a spouse. When one dies the property will be taxed at full value when it transfers to the other. Estate tax may also be owing a second time on the full value of the property when the second spouse dies. Maintain individual ownership. Planning will also be required with future options – selling, gifting or willing – to ensure you minimize taxes but assuming you don't bring in a tenant and are mindful of residency qualifications there will be no income tax to pay. If you decide to rent you will have to report the income on a Foreign Income Verification Statement using a T1135 form in Canada. To find out more about your foreign income reporting obligations including definitions and deadlines visit the CRA site: T1135 Foreign Income Verification Statement Make note, the U.S. levies an immediate 30% withholding tax on the gross amount of any rent paid by a U.S. tenant to a Canadian owner. You can opt for a special election to file taxes on a net basis, which allows you to take into account mortgage interest, maintenance costs, insurance, property taxes, any fees paid to a property management firm and other costs. Although that takes a bit of work – people may need the assistance of a tax advisor – the net amount of rental income will be taxable at marginal rates, which are often a lot less than the 30% withholding.