Tax Issues for Canadians with U.S. Property Holdings

Due to the proximity of Canada to the U.S., it is not surprising that many Canadians own real estate properties in the U.S. Some, especially those who are retired "snowbirds" also spend a good part of the year in the U.S. It is important to understand what the tax implications are – both in the U.S. and in Canada – when you own, rent out or sell your U.S. property. This article will provide a general overview of the issues involved in these situations.

Please note that the comments in this article apply only to non-U.S. citizens who are not green card holders, i.e. you are regarded as a "non-resident alien" by the U.S.

Owning U. S. Real Estate Property

U.S. Implications

One issue that needs to be addressed by those individuals, who own U.S. real estate **and** actually spend part of the year in the U.S., is whether your tax status changes for purposes of the Internal Revenue Service (IRS), by virtue of the time spent in the U.S. More specifically, are you still considered a "non-resident alien" or have you become a "resident alien" because you stayed in the U.S. too long?

In the eyes of the IRS, you will be considered a U.S. resident for tax purposes if you meet the "substantial presence test". In brief:

- If you spend 183 days or more in the U.S. during the current year, you are considered a resident alien.
- If you spend less than 31 days in the U.S. during the current year, you are considered a non-resident alien.
- If you spend between 31 and 183 days in the U.S., you will need to determine the number of days you spend in the U.S. during a 3-year period (the current and 2 previous years). If under this test you are considered a resident alien, you can still be treated as a non-resident alien if:
  - You spend less than 183 days in the U.S. in the current year;
  - You maintain your tax home in Canada during the year; and
  - You have a closer connection to Canada than to the U.S.

To claim that you have a closer connection to Canada, you need to file an IRS form, the *Closer Connection Exception Statement for Aliens (Form 8840)*.

The importance of this distinction is that:

1. Resident aliens are taxed in the U.S. on income from all sources worldwide; while non-resident aliens are generally taxed in the U.S. only on income from U.S. sources.
2. Resident aliens have to file a U.S. tax return to report worldwide income if their annual gross income exceeds certain U.S. dollar amounts.

Canadian Implications

Canadian residents who at any time during the year own foreign investment property (called "specified foreign property") costing more than $100,000 are required to file the Form 1135 *Foreign Income Verification Statement*.

"Specified foreign property" includes real estate situated outside Canada, but does not include personal-use property, that is, any property used mainly for personal use and enjoyment.

Therefore, if you own a condominium in Florida that costs over $100,000, but which is utilized purely for personal use and enjoyment, you would not need to report the condominium. However, if the condominium is utilized for personal use for 4 months of the year and is rented out for 8 months of the year for profit, the property is considered to be an income-earning investment property not held primarily for personal use and enjoyment. As a result, you are required to file Form 1135.

Renting out U. S. Real Estate Property

U.S. Tax Implications

Non-resident aliens of the U.S. are subject to U.S. income tax on two categories of income:

- Income that is not effectively connected with a trade or business in the U.S. but is from a U.S. source (e.g. interest, dividends, rent); and
- Income that is effectively connected with a trade or business in the U.S. (e.g. income from sale of U.S. real property).

It is important to distinguish between these two types of income: “effectively connected income” (after allowable deductions) is taxed at the same graduated rates that apply to U.S. citizens and residents; whereas income that is not effectively connected is taxed at a flat 30% (or lower treaty) rate.

If you are a non-resident alien who receives rental income from your U.S. property, you are not normally required to file a U.S. tax return to report the rental income. The gross rent will simply be subject to a flat U.S. tax of 30% with no expenses or deductions allowed; and the tenant or management agent is required to withhold the 30% non-resident tax from the gross rent and remit the same to IRS.

The advantage of this approach is that you do not have to file a U.S. tax return; however you will not be able to deduct any expenses either. Therefore, you may elect instead to pay U.S. tax on a net income basis, i.e. after all deductible expenses. You can do this by filing a U. S. Non-resident Alien Income Tax Return (Form 1040NR). Doing so enables you to claim related expenses and be taxed on the net rental income at your marginal tax rate. This generally results in a lower tax liability than having the gross rental income subject to the 30% withholding tax.

Things to consider if you prefer to be taxed on a net rental basis

1) The deadline for filing the U.S. tax return is June 15th of the year following the calendar year in question.

   Note that if the property is jointly owned, each owner must file a separate tax return to report their share of the rental income and expenses.

2) Rules relating to expense claims:

- The property must be rented for a minimum of 15 days.
- In addition, if the property is used for personal purposes for more than 15 days in a year, you cannot report a loss from the property.

- Order of expense claims:
  a. Direct expenses first (e.g. agent’s fees)
  b. Operating expenses (e.g. utilities, maintenance) *NB - only expenses relating to the days the property is actually rented can be claimed.*
  c. Depreciation.

3) Instead of filing Form 1040NR and then waiting for the refund of the excess U.S. tax paid, obtain exemption from the 30% non-resident withholding tax by completing Form W-8EC1 (Certificate of Foreign Person’s Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the U.S.) and submitting it to the tenant or management agent.

Canadian Tax Implications

If you are a Canadian resident, you must pay tax on your worldwide income. Accordingly, you must report your net foreign rental income in Canada on your Canadian income tax return. However, a foreign tax credit may be claimed to avoid double taxation. The tax credit is equal to the lesser of the U.S. tax paid and the Canadian tax on that income.

Selling U. S. Real Estate Property

U.S. Tax Implications

When a non-resident alien sells their U.S. real estate, the resulting gain or loss is required to be reported to the IRS by filing Form 1040NR. The purchaser is required to withhold 10% of the gross sale price if the sale price exceeds US $300,000. Withholding is not required where the purchaser acquires the property for use as a residence and the sale price is not more than US $300,000.

The tax normally required to be withheld on a disposition can be reduced or eliminated if you obtain a withholding certificate (Form 8288-B) from the IRS.

The IRS will issue the withholding certificate if the amount required to be withheld would be more than the maximum tax liability. Therefore if you expect the tax liability on the sale of your U.S. property to be less than 10% of the gross sale price, you should request the withholding certificate and file it before the closing date of the sale. The certificate, if granted, will specify the amount of tax to be withheld instead of the full 10%.

Canadian Tax Implications

On the Canadian side, a taxable capital gain may also result from the sale of the U.S. property. A tax credit is available with respect to related U.S. tax paid to eliminate double taxation.

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It may also be possible to claim principal residence exemption for all or part of the gain on the sale. However, careful consideration should be made here, because if there is no Canadian tax payable (due to the exemption), the U.S. tax paid will not receive tax credit in Canada.

Remember also that the gain or loss arising from foreign currency fluctuations between the time the property was purchased and its sale will be factored into the computation of the Canadian gain or loss.

Tax Implications on Death

Please refer to the following articles, “U.S. Federal Estate Tax Implications for Canadians – Determining if you have any Liability” and “U.S. Federal Estate Tax Implications for Canadians – Strategies to Minimize U.S. Federal Estate Tax Liability” for information on the application of U.S. estate tax when a Canadian dies owning U.S. real property.

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