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Privately Speaking

Tax issues relevant to privately owned businesses

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Owning and enjoying US real estate

Over the last several years, numerous Canadians have entered into the US real estate market and have purchased homes for a variety of reasons. Some have purchased the home solely for personal purposes, generally in pursuit of nicer winter weather, while others have used the property as another investment asset in their portfolio and thus have rented the property out to third parties either on a full-time or part-time basis.

Regardless of the specific ownership intention, the tax consequences, especially those applicable in the United States and how they interact with the Canadian tax issues, are quite often not fully addressed. Such issues apply prior to the purchase of the property, during its ownership period, as well as on the sale of the property. Failing to provide this additional attention can potentially lead to adverse tax consequences that may be difficult to avoid at a future date. The purpose of this article is to identify some of these issues at the various stages in the ownership period so that proper consideration can be given.

Issues to consider prior to purchase

Unlike Canada, the United States imposes an estate tax on the fair market value (FMV) of the assets held by an individual at the time of death, and a gift

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tax on the FMV of assets donated during the life of the transferor.[1] The estate or gift tax is sometimes referred to as a "balance sheet tax" since the tax is determined as a percentage of the asset's FMV at the time of death/gift as opposed to a percentage of the capital gain that may be inherent in the asset upon death/gift. Currently, the top marginal estate tax rate in the United States is 40%. For individuals who are not citizens or residents of the United States for purposes of estate tax, the tax is only imposed on the individual's assets situated in the United States (often referred to as "US situs assets") as opposed to all assets. US situs assets include, among other things, US real estate and, for purposes of the estate tax, shares in US resident corporations. The United States exempts its citizens and residents from estate or gift tax on the first $5.45 million worth of assets.[2] However non-residents do not enjoy such an exemption amount. Instead, pursuant to the Canada-US Income Tax Convention (the "Treaty"), Canadians are eligible for a pro-rated exemption in the case of estate tax. For example, if, on the death of a Canadian resident, the value of the individual's US home and other US situs assets made up 10% of the individual's total worldwide asset holdings, then he or she should be entitled to an estate tax exemption of $545,000 (or $1,090,000 if the asset is transferred to a Canadian resident spouse). As a result, Canadian individuals with significant wealth should consider steps to quantify, mitigate and/or defer the imposition of estate tax when considering the purchase of US real estate.

Various strategies to mitigate the effect of US estate tax have been developed. Such strategies range from purchasing additional life insurance, amending the individual and/or their spouse's will in order to tax efficiently transfer the property to another on death, to holding the property within an alternate vehicle such as a trust which holds the property for the benefit of family members. As each strategy has its own unique advantages and disadvantages, they must be evaluated on a case-by-case basis given that each individual has his or her own objectives. In many cases, strategies can be combined in order to increase effectiveness. It is highly recommended, especially for those individuals with significant asset holdings, to consult with their tax advisor in order to identify which potential strategies would be the most effective for their unique objectives. Such consultation should be completed prior to the purchase of the property as the implementation of certain strategies may become cost prohibitive where the property is already owned.

Issues to consider during ownership

Where the US property is rented to a third party during a particular year, US Federal and, potentially, state income tax would apply to such rental income. Absent any elections, such tax is imposed at a rate of 30% of the gross rents received with no consideration for the operating expenses incurred by the owner. However, an election is available whereby the non-resident can elect to be taxed only on the annual net rental income earned, with such tax being calculated in reference to the graduated income tax rates and brackets. Such

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[1] Canada does not impose an estate or gift tax but rather, with some exceptions, deems the individual to have disposed of the property just prior to death, or gift, with any accrued capital gains being subject to income tax.

[2] For the 2016 taxation year, the exemption was $5.45 million, although such amount is indexed for inflation.

election is generally beneficial since the taxpayer is able to deduct the operating expenses (e.g., mortgage interest, real estate taxes, insurance, repairs and maintenance, etc.) in calculating his or her taxable income. In making such election, the taxpayer is required to file an annual US tax return (federal and state where applicable) to report such income. Such rental income remains taxable in Canada given that the taxpayer is also a resident of Canada. However, the foreign tax credit mechanisms are designed to mitigate against double taxation.

Even where an individual may not rent his or her US real estate during the year, but rather uses it solely for personal enjoyment, there may still be annual US tax consequences that need to be considered. For individuals who are not US citizens or lawful permanent residents of the US, referred to as "greencard holders", the United States determines if the individual is a US resident for tax purposes based on the number of days the individual was physically present in the United States for any reason (where any part of a day is considered a full day) over a three year period. Such determination is generally referred to as the "substantial presence test" or "SPT". Should the sum of the specified formula be equal to 183 or more, the individual is considered to have met the SPT and thus is considered a US resident unless another opportunity to break US residency is available.

Individuals who meet the SPT but were present in the United States for less than 183 days in the current year alone, may still be considered to be non-residents of the United States for tax purposes provided they have a closer connection with another country and file Form 8840, Closer Connection Exception Statement for Aliens on or before the US tax return filing deadline (generally, April 15 or June 15 of the following year). Failure to file such form in a timely manner, or surpassing 183 days of US physical presence in a particular year, may lead to a requirement for the individual to file significantly detailed asset disclosure forms in the United States which can lead to significant additional tax compliance costs. Therefore, individuals should take care in managing the number of days in the United States each year and take the appropriate steps to ensure compliance with US tax and asset disclosure rules while doing so in the most efficient manner. Failure to do so may result in the imposition of significant penalties.

Issues to consider at the time of sale

Similar to the fact that US income tax consequences should be considered both prior to and during the US real estate ownership period, additional considerations need to be addressed upon the sale of the property.

Capital gains realized on the disposition of US real estate are taxable in the United States both at the federal and potentially state level. Such gain is also subject to Canadian taxation, including any foreign exchange gain realized on the disposition; however, the foreign tax credit mechanism is designed to mitigate against potential double taxation. In order to ensure it is able to collect the tax due on the sale of the property, the United States imposes a withholding requirement on the sale proceeds. Absent prior action and with some exceptions, the purchaser of the property is required to withhold and remit 15% of the gross selling proceeds to the Internal Revenue Service ("IRS") in lieu of the foreign sellers' potential tax liability.[3] The seller than prepares a US income tax return to report the capital gain or loss realized on the sale. The amount of the withholding in excess of the seller's liability is refunded by the IRS after processing the tax return.

Given the potential delay between the date of sale and the date that the IRS receives and subsequently processes the seller's tax return, significant negative cash flow implications can be placed on the seller. In recognition of this, the IRS has introduced a process whereby sellers can notify the IRS of a pending sale and ask that the IRS reduce the purchaser's withholding obligation to the amount of the expected tax liability as opposed to 15% of the gross proceeds. The process allows for the purchaser to hold the full amount of the withholding in escrow until the IRS has responded to the request for a reduction. However, in practice, many title companies will not hold funds in escrow but rather will remit the full amount of the withholding immediately upon closing as a matter of company policy. For this reason, and the fact that IRS processing delays may be encountered with respect to withholding reduction applications especially where the seller needs to apply for a US Individual Taxpayer Identification Number ("ITIN"), the process of applying for a reduced withholding obligation should be commenced as soon as possible once a tentative agreement to sell has been reached. Where a withholding reduction certificate cannot be obtained prior to closing and the title company will remit immediately upon closing, an expedited refund may be requested from the IRS. Regardless of the methodology used to mitigate the negative cash flow implications associated with the withholding requirement, a US income tax return should be filed to report such disposition. The tax return is generally due on or before April 15 or June 15 of the following year.

In the event that the individual dies prior to the sale of the property, a US estate tax return would be required to report any estate tax that may be due. Estate tax returns are generally due within 9 months of death.

Can we be of assistance?

If you would like to discuss the tax implications of your US real estate, please contact your local Deloitte Private tax representative. We would be happy to be of assistance.

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[3] Some states also impose such withholding requirements at the state level.