Owning U.S. Real Estate

Owning real estate in the U.S. may be appealing to Canadians for many reasons. Some own a vacation property to escape the winter months, while others purchase a home or condo for a child pursuing post-secondary education in the U.S. Whether you are buying, selling, or earning rental income from a U.S. property, there are a myriad of planning and compliance issues to consider on both sides of the border.

This article is intended for Canadian residents who are not U.S. citizens or green card holders and are not U.S. residents (collectively referred to as a "U.S. person"). The tax considerations discussed in this article may not be applicable for Canadian residents who are U.S. persons.

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Financing considerations

When considering a mortgage for the purchase of real estate in the U.S., please note that not all Canadian lenders offer mortgages on U.S. properties. In addition, there are a number of key differences between the Canadian and U.S. market that you should consider when looking to secure a U.S. mortgage:

- In the U.S., a mortgage application may take longer than a typical mortgage application process in Canada.
- Securing a U.S. mortgage may require additional documentation.
- There may be higher costs involved in obtaining a U.S. mortgage. Buyers can expect to pay higher third-party expenses such as property appraisal, title and other insurance requirements.
- U.S. fixed-rate mortgages are typically compounded monthly, while in Canada they may be compounded semi-annually on fixed-rate mortgages.

U.S. tax considerations

The U.S. tax implications will depend on whether a property was purchased for personal use or for investment/rental purposes. This choice may affect how many days someone chooses to spend in the U.S., which in turn may result in a U.S. tax filing obligation.

> If an individual is not a U.S. citizen, for U.S. tax purposes, he or she is considered either a **resident alien** or a **nonresident alien**.

Depending on how many days an individual spends in the U.S., residency for U.S. tax purposes could change. If an individual is not a U.S. citizen, for U.S. tax purposes, he or she is considered either a **resident alien** or a **nonresident alien**. Resident aliens are subject to U.S. tax on worldwide income from all sources and generally, are required to file an annual U.S. income tax return. In contrast, nonresident aliens are generally only taxed on income from U.S. sources.

A **resident alien** is an individual who is either a green card holder or has satisfied the “substantial presence test”. Factors for the substantial presence test are as follows:

- If someone spends 183 days or more in the U.S. during the current year, the substantial presence test has been met and that individual would be considered a resident alien.
- If someone spends between 31 and 183 days in the U.S. during the current year, he or she will need to determine the number of days spent in the U.S. over a rolling three-year period (the current and the two previous years) using the “183-day test”. The test is calculated by adding the sum of: (i) all of the days of physical presence in the U.S. in the current year, (ii) one-third of the days of physical presence in the first preceding year, and (iii) one-sixth of the days of physical presence in the second preceding year. If the total equals 183 days or more, then the substantial presence test has been met, and that individual may be considered a resident alien.
- If someone spends less than 31 days in the U.S. during the current year, he or she is considered to be a nonresident alien.

If the substantial presence test is satisfied, an individual may still be treated as a nonresident alien if he or she meets the “closer connection” exception:

- He or she spends less than 183 days in the U.S. in the year;
- He or she maintains a “tax home” in Canada during the year; and,
- He or she has a closer connection, such as maintaining more significant ties, to Canada than to the U.S.,

In order to claim the closer connection exception, Form 8840 — *Closer Connection Exception Statement for Aliens* would need to be filed with the Internal Revenue Service (IRS) by April 15th of the following year.

If the closer connection exception cannot be claimed, U.S. income taxes may be avoided under the residency tiebreaker rules in the *Canada-United States Tax Convention* (*the Treaty*). Where someone relies on the residency tiebreaker rules of the Treaty to maintain

Canadian residency, U.S. income taxes may not be payable however a U.S. tax return would still be required to claim the Treaty benefit, and any applicable foreign reporting required under U.S. tax laws may still be necessary.

If you spend a significant amount of time in the U.S., you should speak with a cross-border tax advisor to ensure you understand the tax implications to prevent any unintended consequences.

Canadian tax considerations

Canadian residents who own foreign investment property (called "specified foreign property") at any time during the year costing more than $100,000 are required to file Form T1135 *Foreign Income Verification Statement*.

"Specified foreign property" includes real estate situated outside of Canada, but does not include personal-use property — property used primarily for personal use and enjoyment purposes. The Canada Revenue Agency (CRA) takes the view that "primarily" means more than 50%. For example, if Mr. Jones owns a condominium in Florida that costs over $100,000, but it is maintained exclusively for personal use, he would not need to report it on Form T1135. However, if Mr. Jones occupies the condominium for personal use for only four months of the year, and rents it out for the remaining eight months of the year, it would likely be considered an income-earning investment property. As a result, Mr. Jones would likely be required to report the property on a Form T1135.

There are substantial penalties for failing to complete and file Form T1135 accurately and on time.

Renting out U.S. real estate

For Canadians owning U.S. real estate, rental income from such U.S. property will generally be treated as gross rental income in the U.S. and would be subject to a 30% U.S. withholding tax. However, for Canadian tax purposes it is the net rental income that is reported on a Canadian tax return. To mitigate double taxation, a foreign tax credit may be available under the *Income Tax Act (Canada)* for U.S. withholding taxes paid.

Alternatively, to avoid the 30% U.S. withholding tax, an election may be made by filing a U.S. nonresident alien tax return. The election would generally apply to all subsequent tax years. Where the election is made, 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* would need to be provided to a withholding agent or payer of the rental income to avoid the U.S. withholding tax. To determine whether this option is appropriate in your particular circumstances, please consult with your cross-border tax advisor.

Selling U.S. real estate

U.S. tax considerations

When a nonresident alien sells, exchanges, gifts or otherwise transfers their U.S. property, the sale proceeds/amount realized may be subject to withholding tax under the *Foreign Investment in Real Property Tax Act (FIRPTA).* Under the *FIRPTA* rules, the purchaser is generally required to withhold 15% of the gross sale proceeds. However, a reduced withholding rate may apply where the purchaser acquires the property for use as a residence. In such case, if the sale proceeds are greater than US$300,000 but do not exceed US$1,000,000, the withholding rate is reduced to 10% and if the sale proceeds are US$300,000 or less, withholding is not required. The rate of withholding is 15% when the amount realized is in excess of US$1,000,000.

The tax normally required to be withheld on a disposition may be reduced or eliminated where a withholding certificate is obtained from the IRS. An application for a withholding certificate would need to be submitted on Form 8288-B — *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests.* Where the tax liability on the sale of U.S. property is expected to be less than the applicable *FIRPTA* withholding rate on the gross sale proceeds, consider requesting a withholding certificate well in advance of the closing date of the sale. The certificate, if granted, will specify the amount of tax to be withheld instead of the applicable FIRPTA withholding amount.

Canadian tax considerations

When a capital gain is realized on the sale of a U.S. property, the taxable capital gain would be subject to Canadian taxes.

For property bought and sold in a foreign currency, the adjusted cost basis (ACB) and proceeds of the sale must be converted to Canadian dollars for tax reporting purposes. Any foreign exchange component associated with the sale would typically need to be reported on a capital gain (or loss) report. A foreign tax credit for the U.S. taxes paid may be claimed to reduce Canadian taxes arising from the sale of the property. The principal residence exemption may be available for all or part of the gain on the sale.

However, if there is no Canadian tax payable due to the exemption, U.S. taxes paid that are eligible for foreign tax credit relief may go unused. To determine whether it is appropriate, in your particular circumstances, to claim the principal residence exemption on the sale of your U.S. property, please consult with your tax advisor.

Tax considerations on death

Canadians may be subject to U.S. estate taxes if, at the time of their death, the value of their U.S. situs assets, such as a U.S. real estate property, exceeds US$60,000 and the value of their worldwide assets is more than US$11.58 million (in 2020, adjusted annually for inflation). The maximum federal estate tax rate is currently 40%. Please note that if at the time of death, the value of a Canadian's U.S. property is over the US$60,000 threshold, a U.S. estate tax return is required, whether or not U.S. estate tax is payable. The deadline to file this return is nine months following the date of death.

It should be noted that U.S. tax reform enacted at the end of 2017, doubled the basic exclusion amount through 2025. However, unless new legislation is enacted, the exclusion amount will return to the pre-2018 exclusion amount of US$5 million, adjusted for inflation.

Planning may be undertaken to mitigate potential exposure to U.S. estate tax and may include strategies on who should own the property and how to specifically take title of the U.S. property. Ideally, such planning should be considered and implemented prior to the purchase of the U.S. property. Due to frequent changes to the U.S. estate tax rules, planning that is undertaken may need to be revisited regularly with a cross-border tax advisor.

Other considerations

Canadians who own property in the U.S. should consider whether or not their estate planning documents, specifically their Power of Attorney (POA), are valid in the specific U.S. state where their property is located. It may be advisable to have a POA prepared according to the laws of each jurisdiction in which you own property of significant value. This ensures your property can be appropriately managed in the event that you are unable to do so yourself. To determine whether you may need a specific POA for your U.S. property, please consult with your cross-border legal advisor. If you decide to have multiple POAs, it is important that due care be taken to ensure these documents contain specific language to prevent unintended revocation of each other.

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Please note that to avoid and/or minimize probate fees on your U.S. property, there are particular probate planning strategies unique to the U.S. Prior to undertaking such probate planning, you should discuss the potential tax and legal implications with your tax and legal advisors. Additionally, it is important to note that while certain planning strategies may be effective for probate purposes, such strategies may not be effective in sheltering your estate from U.S. estate tax.

Conclusion

Consider speaking with your TD advisor and a cross-border tax and legal advisor about the financing, tax, and other considerations involved in owning a U.S. property.