IG PRIVATE WEALTH MANAGEMENT

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Canadians Owning Vacation Properties in the U.S.

We will cover the following topics:

01 A brief discussion of ownership structures for U.S. real estate

02 Owning U.S. real estate personally, including the implications of:

- Passing away while owning U.S. real estate including a discussion of U.S. estate tax
- Gifting U.S. real estate
- Selling U.S. real estate

03 Renting your personally-held U.S. real estate

04 Residency considerations, including:

- The Substantial Presence Test
- The Closer Connection Exception
- The Treaty Exemption

With our cold winter climate, many Canadians dream of spending more time in the sun. If you are thinking of making this dream a reality and buying a home in Florida, Arizona or another warm-weather destination in the U.S, it's important to consider the tax implications on both sides of the border.

This article provides a brief overview of selected U.S. and Canadian income tax consequences for Canadians owning U.S. real estate as personal-use property. We also briefly discuss some of the implications of renting your property.

Unless otherwise indicated, we assume that the individuals involved are not U.S. citizens, U.S. green cardholders or U.S. residents. Please also note that the discussion in this article is for informational purposes only and does not represent tax or legal advice. We recommend that you speak to your cross-border tax advisor about both the Canadian and U.S. consequences of your circumstances, prior to taking any actions.

> *If Canadian residents (who are not U.S. citizens) are considering the purchase of U.S. real estate, joint ownership is not always the best way to take title.*

HOLDING U.S. PROPERTY PERSONALLY

After deciding on the U.S. property you want to buy, one of the most important decisions is how the U.S. real estate should be purchased – personally, through a trust, by your corporation or in another way. The decision is significant as each method has tax implications which you should discuss with your U.S. cross-border advisor prior to the purchase.

The most common way to purchase U.S. real estate is also the simplest – owning it personally. Owning U.S. real estate personally eliminates much of the complexity inherent with other forms of ownership. On the other hand, when U.S. property is owned personally, you must consider the potential impact on the individual's U.S. estate tax exposure and their personal liability exposure.

JOINT OWNERSHIP

In Canada, many spouses own property as joint owners with the right of survivorship. This allows the property to pass directly to the surviving spouse outside of the probate process that exists in all provinces other than Quebec. In the U.S., joint ownership by spouses is used for the same reasons. However, if Canadian residents (who are not U.S. citizens) are considering the purchase of U.S. real estate, joint ownership is not always the best way to take title. If your worldwide estate is large enough, you may have an exposure to U.S. estate tax and joint ownership can exacerbate an estate tax problem. With joint ownership, when one spouse passes away and the surviving spouse is not a U.S. citizen, the entire value of the property will be included in the U.S. estate tax calculation at the death of the first spouse to die, unless it can be proven that the surviving spouse used their own capital to fund a portion of the property purchase. Assuming the surviving spouse continues to own the property, the entire value of the property could be taxed again on the death of the surviving spouse.

As a result, it is important to determine if U.S. estate tax is a concern, which will depend on the value of your worldwide estate and the U.S. estate tax exemptions available. If U.S. estate tax is a concern, Canadians should generally not own U.S. real estate as joint tenants with rights of survivorship, particularly if there is no clear record that each spouse contributed equally to the purchase of the property.

When spouses purchase U.S. property in joint tenancy and one spouse has provided more funds for the purchase than the other spouse, there may be unintended U.S. gift tax consequences upon the creation or termination of the joint tenancy. You should speak with your cross-border advisor to ensure that your purchase is structured to minimize the impact of the gift tax rules.

USING A CANADIAN DISCRETIONARY TRUST

If the taxpayer's worldwide estate is high enough such that their U.S. estate tax exposure cannot be managed using their unified credit and marital credit, if applicable, an alternative way of holding the U.S. real estate is holding it in a Canadian discretionary trust. If the trust is set-up properly, U.S. estate tax could be eliminated as, on death, the property would be owned by the trust as opposed to by the individual. It is important that the trust be specifically designed such that it does not trigger U.S. estate tax and, as these rules are very complicated, we strongly recommend that you speak with a U.S. cross-border advisor prior to purchasing the property.

USING A REVOCABLE LIVING TRUST

Revocable trusts are often used as a probate avoidance vehicle in the U.S. The problem is that these trusts are ignored for U.S. tax purposes but recognized for Canadian purposes as a separate taxpayer. In many situations, this structure can create a mismatch between Canadian and US tax reporting at the time of sale or on death, resulting in double taxation for Canadians. Prior to considering a revocable living trust, we recommend discussing your situation with a cross-border tax advisor.

USING A CANADIAN CORPORATION

Many people considering the purchase of U.S. real estate are shareholders of a Canadian corporation and are wondering whether the property should be purchased through their corporation.

Although holding the U.S. real estate within a Canadian corporation may provide an opportunity to avoid U.S. estate taxes, there are several negative tax consequences that arise. It's important to consider that, when a corporation owns real estate and a Canadian shareholder of that corporation uses that real estate for their personal use, the individual would be assessed a taxable shareholder benefit for the fair market value of the rent not paid and that amount must be included on the shareholder's Canadian personal tax return. This, along with other potential negative tax implications, is often a significant deterrent from purchasing a personal-use property in a corporation.

CANADIAN IMPLICATIONS OF HOLDING U.S. PROPERTY ON PASSING

If a Canadian resident passes away while owning U.S. real estate, they are deemed to dispose of that property at its fair market value from a Canadian tax perspective and thus, are taxed on the taxable portion (50%) of any accrued capital gains. An exception to this deemed disposition rule from a Canadian tax perspective occurs if the property is transferred to a surviving spouse or to a spousal trust. A foreign tax credit may be available to offset the federal tax attributable to the gain on the U.S. situs property. There could be double tax if the deceased lived in a province that doesn't allow for a foreign tax credit for U.S. estate tax.

> "Not all provinces allow for a foreign tax credit for U.S. estate tax."

U.S. ESTATE TAX

If a Canadian individual personally owns U.S. real estate, on their death, U.S. estate tax could apply on the fair market value of their U.S. situs assets, including their U.S. real estate.

The U.S. provides U.S. citizens and U.S. residents with a unified credit which shelters $11.58M USD (for 2020) of assets from U.S. estate tax. Fortunately, the Canada-U.S. Tax Treaty, provides Canadians who are U.S. non-resident aliens with a pro-rated portion of this unified credit.

For individuals who are not U.S. citizens or U.S. residents, depending on the value of their U.S. and worldwide assets, they may be able to utilize the pro-rated unified credit to reduce or eliminate their U.S. tax exposure. If a Canadian individual's worldwide estate is less than $11.58M USD (for 2020), they should not have any U.S. estate tax payable, although they will generally have to file a U.S. estate tax return if they held U.S.-situs assets with a value of more than $60,000. The Canada – U.S. Tax Treaty also provides a marital credit for married individuals that could provide further relief.

It is important to continually monitor the value of the unified credit as it has fluctuated historically and is scheduled to decrease significantly at the end of 2025 unless new legislation is introduced.

GIFTING U.S. REAL ESTATE DURING YOUR LIFETIME

Many individuals who personally own U.S. real estate have considered gifting it to their children or other relatives. Unfortunately, for persons who are not citizens of the U.S. or resident in the U.S., the gifting of U.S. real estate can create a greater tax problem than estate tax. The U.S. has a unified system of gift and estate tax such that lifetime transfers are subject to the same tax rates as transfers on death. Non-residents of the U.S. are subject to U.S. gift tax on any gifts of U.S. tangible property, including U.S. real estate.

For U.S. residents and citizens, the unified credit can shelter both lifetime gifts and transfers on death. For non-residents there are only annual exceptions available - if a gift is made to a non-U.S. citizen spouse of up to $157,000 (for 2020) and on gifts of up to $15,000 to anyone other than your spouse. As a result, any amount exceeding these thresholds is subject to U.S. gift tax. The Canada-U.S. treaty does not provide for Canadians to access a pro-rated portion of the lifetime gift tax exemption (unlike U.S. estate tax), meaning the gift tax rules could significantly increase your tax exposure.

Additionally, gifting U.S. real estate could result in double tax. From a Canadian tax perspective, you are deemed to dispose of the property at its fair market value and are taxed on the inherent capital gains. This results in your children having cost base from a Canadian perspective in the property equal to the fair market value on the date of the gift. From a U.S. perspective, the children's cost base will be limited to the parent's cost base plus any gift tax the parents paid. As a result, when the children sell the property in the future, they will be subject to U.S. tax on a portion of the same capital gain that their parents have already paid tax on.

"It is generally not recommended to gift your U.S. property during your lifetime."

For these reasons, it is generally not recommended to gift your U.S. property during your lifetime. Prior to gifting any U.S. real estate, we recommend that you consult with your cross-border advisor.

SELLING U.S. REAL ESTATE

If a Canadian resident sells their U.S. real estate, they are subject to a 15% withholding tax on the gross sales price of the property. An exemption is available in a situation where the property is sold for less than $300,000 USD, and the buyer certifies that they intend to occupy the property as their principal residence for the first two years. In that instance, the withholding tax rate is reduced to 0%. If the selling price is greater than $300,000 USD but less than $1,000,000 USD and the buyer certifies that they are purchasing the property with the intention of it being used as their principal residence, then the withholding tax rate is reduced to 10% of the gross sales proceeds. Any tax withheld will be used to offset the ultimate U.S. tax liability on the gain realized on the sale and will be refunded if it exceeds the U.S. tax liability when the taxpayer files their U.S. tax return.

Another exception from the general withholding tax regime occurs when the Canadian resident applies for and receives a withholding tax certificate from the IRS. The certificate will indicate the amount of tax that must be withheld (as opposed to the full 10% or 15% of the gross proceeds noted above).

Regardless of the impact on the withholding tax, when U.S. real property is sold by a non-resident, the sale is required to be reported in the U.S. and a 1040NR U.S. tax return must be filed. Additionally, as a Canadian resident is subject to tax on their worldwide income in Canada, the gain or loss on the sale of their U.S. property would also be subject to tax in Canada. To minimize the incidence of double taxation, you would generally receive a foreign tax credit in Canada for any taxes paid in the U.S.

It is important to note that the capital gain or loss in Canada may differ from the capital gain or loss in the U.S. The sale proceeds of the property must be converted to Canadian dollars using the foreign exchange rate on the date of the sale (or the average foreign exchange rate for the year of sale), while the adjusted cost base must be converted to Canadian dollars using the foreign exchange rate on the date of purchase (or the average foreign exchange rate in the year of purchase). If the foreign exchange rate has fluctuated significantly from when the property was purchased, the gain or loss in Canada may differ significantly from the gain or loss in the U.S.

> *Speak with a U.S. cross-border advisor if you are considering renting out your property, as rental properties are subject to additional considerations.*

RENTING YOUR U.S. REAL ESTATE

When a Canadian personally owns U.S. real estate and rents out that U.S. real estate, several additional considerations arise such as the increased exposure to liability. As a result, creditor protection and liability insurance often become important considerations.

From a taxation perspective, when a Canadian resident earns rental income from their U.S. real property, they are subject to U.S. non-resident withholding tax of 30% on their gross rental income. That means that instead of receiving $1,000 of rental income, you would only receive $700, with the remaining $300 being sent to the IRS. In this circumstance, assuming your only connection to the U.S is holding U.S. real estate, you would not have to file a U.S. tax return. Instead of being subject to such a high U.S. withholding tax on your gross rental income, non-residents of the U.S. can elect to be taxed on their net rental income from the U.S. property, providing them with the ability to deduct reasonable expenses related to earning their rental income. In order to do this, you would be required to complete Form W-8ECI and provide the form to the person paying you the rent and you must file a non-resident U.S. tax return to report the rental income earned.

It is imperative that you speak with a cross-border advisor if you are considering renting out your property as rental properties are subject to additional considerations and the ownership structure could have additional implications.

RESIDENCY

Once you purchase a home in the U.S., the appeal of the sun and warmer weather may have you spending more time south of the border. Although you will enjoy spending time at your new vacation property, it's important to consider how spending time in the U.S. may impact whether the U.S. views you as a U.S. resident for tax purposes. A U.S. resident would be required to file Form 1040 U.S. Individual Income Tax Return and would be taxable in the U.S. on their worldwide income.

Substantial Presence Test

Even if you are in the U.S. for less than 183 days in the current year, the U.S. has a substantial presence test to determine if you are considered a U.S. resident under U.S. domestic law. This substantial presence test is a two-part test that looks at the number of days you were in the U.S. in the current year and each of two most recent prior years using the following formula:

- All of the days spent in the U.S. the current year
- ⅓ of the number of days spent in the U.S. in the immediately preceding year
- ⅙ of the number of days spent in the U.S. in the second preceding year

To be considered substantially present in the U.S., you must be physically present in the U.S. for at least 31 days in the current year and the result of the formula above must be 183 days or more. If you meet the substantial presence test, you are considered a U.S. resident unless an exception applies.

As a general guideline, if you spend 122 days or more in the U.S. each year, you will meet the substantial presence test after the third year and in every year moving forward.

Example:

Let's say you spent 126 days in the U.S. in the current year (2020) and in each of the two previous years (2018 and 2019). As such, you would have spent over 31 days in the U.S. in the current year and the result of the formula above would be 189 days of presence within the U.S. over the three-year period. As this meets both the 31-day threshold in the current year and the 183-day threshold based on the formula over the three-year period, you would meet the substantial presence test for 2020 and would be considered a U.S. resident unless an exclusion applies.

If you are considered a U.S. resident under the substantial presence test, two options that may be available are to claim a Closer Connection Exception or to rely on the Canada-U.S. Treaty Exemption.

Closer Connection Exception

Even if an individual meets the substantial presence test, that individual may still be considered a U.S. non-resident if they qualify for the Closer Connection Exception. The Closer Connection Exception can apply where the individual:

1. Has been physically present in the U.S. for less than 183 days in the current year;
2. Maintains a tax home in a foreign country (i.e. Canada) during the year; and
3. Has a closer connection (permanent home, family, personal belongings, social ties, the country of residence designated on forms and documents) with that foreign country (i.e. Canada) than the U.S. during the year

As U.S. residents are subject to U.S. tax on their worldwide income while U.S. non-residents are subject to taxation in the U.S. in only limited circumstances, if this exception is available, it is normally beneficial to claim it. To claim this exception, the taxpayer must file Form 8840 "Closer Connection Exception Statement For Aliens" with the IRS by June 15th of the following year.

Treaty Exemption

If you have spent 183 days or more in the U.S. in the current year, the Closer Connection Exception will not be available. If you meet the treaty exemption, discussed further below, you would be deemed a resident of Canada and thus, a non-resident of the U.S.

"If you have spent 183 days or more in the U.S. in the current year, the Closer Connection Exception will not be available."

If you are considered to be a resident of Canada and the U.S. under both country's domestic tax rules, the "tie breaker rules" in the Canada – U.S. Income Tax Treaty can be used to determine where you are resident. If, under the tie-breaker rules, you are considered a deemed resident of Canada and therefore deemed to be a non-resident of the U.S., you can claim a treaty exemption. In order to claim a treaty exemption, you must file a U.S. non-resident tax return and attach a treaty exemption statement (Form 8833), indicating that you are a resident of Canada under the Canada – U.S. Income Tax Treaty.

When considering the substantial presence test, the Closer Connection Exception or the Treaty Exemption, it is important to consult with your cross-border tax advisor for proper planning advice for your circumstances.

As you can see, the purchase of a new U.S. vacation property can be an exciting time but along with the excitement and the advantages of owning a U.S. vacation property, there are many more factors to consider. When making this decision, it is important to speak to a cross-border tax advisor about both the Canadian and U.S. consequences of your unique situation.

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Blair is Director, Tax & Estate Planning at IG Wealth Management, where he specializes in providing tax and estate planning advice to high net worth clients on complex issues. Blair is a Chartered Professional Accountant specializing in Canadian taxation and has completed the In-Depth Tax program in 2011. Blair obtained his Certified Financial Planner designation in 2018, ranking on FP Canada's President's List, which recognizes the top three successful candidates. Blair has more than eleven years of experience with a large national public accounting firm. He has a breadth of experience providing clients with advice on matters including corporate taxation, transaction structuring and tax planning for high net worth individuals and their businesses.

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