U.S. Tax Exposure From Owning U.S. Rental Properties

Wealth Management Taxation, The Bank of Nova Scotia

Often, Canadian "snowbirds" purchase real estate in the United States ("U.S."), and rent it out in order to earn rental income. When a Canadian resident (regardless of U.S. citizenship) owns a U.S. rental property, there are U.S. tax implications from earning rental income, as well as exposure to U.S. estate tax when the Canadian passes away. This article outlines the U.S. tax implications with regards to a U.S. rental property owned by a Canadian resident.

Tax implications — rental income

A Canadian resident with a U.S. rental property will be subject to income taxes on the rental income in both the U.S. and Canada. Fortunately, Canada allows a foreign tax credit ("FTC") for the U.S. taxes paid in relation to the income that is also taxable in Canada. The FTC alleviates the problem of double-taxation. A Canadian resident is required to remit withholding taxes on the rental income earned from a U.S. property to the Internal Revenue Service ("IRS"), at a rate of 30% of the gross rental income. Alternatively, one can elect to pay tax on net rental income by filing a U.S. non-resident tax return reporting net rental income.

Tax implications — sale of the U.S. properties

A capital gain or loss arising as a result of selling a U.S. property is required to be reported on a U.S. Individual Income Tax Return. Capital gains in the U.S. are categorized as either short-term or long-term depending on the period of ownership of the asset being sold. The tax treatment differs for each category. For short-term capital gains, (period of ownership of the asset less than 12 months), the gain is taxed at the individual's progressive tax rate. Otherwise, a flat long-term capital gain tax rate of 20% will apply. The purchaser is required to withhold tax at 10% or 15% of the gross sales price of the property, depending on the date of disposition and type of property. One may apply to reduce the withholding tax rate to the actual U.S. tax liability by filing U.S. Form 8288B — "Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests", by the closing date of the property.

Tax implications — U.S. estate taxes

The U.S. imposes estate tax on the death of an individual at graduated rates, based on the fair market value ("FMV") of the individual's taxable estate. In general, the U.S. taxable estate of a non-U.S. person is comprised of their U.S. situs properties (e.g. U.S. real property, U.S. securities, U.S. mutual funds), net of certain debts and expenses. In the context of U.S. estate taxes, a U.S. person refers to a U.S. citizen or person domiciled in the U.S.

The federal estate tax rate is progressive from 18% to 40% and there is a unified credit of USD $2,125,800 in 2016, which, for a U.S. person, effectively exempts USD $5,450,000 of assets from the estate tax.

Scotia Wealth Management™ Enriched Thinking™

® Registered trademark of The Bank of Nova Scotia, used under licence. ™Trademark of The Bank of Nova Scotia, used under licence. Scotia Wealth Management™ consists of a range of financial services provided by The Bank of Nova Scotia (Scotiabank®); The Bank of Nova Scotia Trust Company (Scotiatrust®); Private Investment Counsel, a service of 1832 Asset Management L.P.; 1832 Asset Management U.S. Inc.; Scotia Wealth Insurance Services Inc.; and ScotiaMcLeod®, a division of Scotia Capital Inc. Business and family advisory services are provided by Scotia Capital Inc. Insurance services are provided by Scotia Wealth Insurance Services Inc. Scotia Capital Inc. is a member of the Canadian Investor Protection Fund and the Investment Industry Regulatory Organization of Canada.

Under U.S. domestic tax law, a Canadian resident is entitled to a unified credit of USD $13,000, exempting U.S. situs assets worth only $60,000. Fortunately, the Canada-U.S. Tax Convention (the "Treaty") allows Canadian residents to enhance their exemption entitlement to the same U.S. $5,450,000 exemption as a U.S. person.

The unified credit is prorated based on the value of U.S situs assets in relation to the value of total worldwide assets, as follows:

$$\frac{\text{Gross value of U.S. situs property}}{\text{Gross value of worldwide assets}} \times \text{U.S. \$2,125,800 of 2016 unified credit}$$

Generally, if the value of the worldwide estate of a Canadian resident (non-U.S. person) is less than U.S. $5,450,000, they should not have a U.S. estate tax liability.

Where both spouses are U.S. citizens, and assets are passed to a surviving U.S. citizen spouse, one can defer the estate tax by claiming the "unlimited marital deduction". There is also the ability to transfer unused exemption amounts between U.S. citizen spouses. This allows the surviving spouse to take advantage of any unused portion of the spouse's estate exclusion amount. As a result, one may double the exemption, to $10,900,000. However, if the surviving spouse is not a U.S. citizen, the unlimited marital deduction is not available. Instead, assets must be transferred to a Qualified Domestic Trust ("QDOT"). Alternatively, a marital credit is available under the Treaty.

To claim the exemption under the Treaty, the Canadian resident must file U.S. Form 706-NA — "United States Estate Tax Return", along with a Form 8833 — "Treaty-Based Return Position Disclosure". The due date for estate tax returns is nine months following the date of death.

Finally, if a Canadian resident does pay any amount of U.S. estate tax, a foreign tax credit may be claimed in their Canadian income tax return, offsetting Canadian income tax paid on U.S. source income or capital gains on dispositions of U.S. assets.

Example

Below is an example of applying the unified and marital credits under the Treaty for Canadian residents.

- Mr. A and Mrs. A are Canadian residents and own a Florida condominium for rental purpose.
- In 2016, Mr. A passed away and the condominium is worth U.S. $2,000,000.
- They do not own any other U.S. situs assets and the total worldwide estate worth U.S. $6,000,000.
- 2016 estate tax rate is 40% for taxable estate value above U.S. $1,000,000 and the unified credit is $2,125,800

U.S. estate tax on $2,000,000	Exemption with Canada-US Treaty
Tax on the first $ 1,000.000:	$345,800
Tax on the balance ($2,000,000 - $1,000,000) at 40%	$400,000
Total U.S. estate tax before unified credit	$745,800
Less: Prorated credit ($2,000,000 / $6,000,000 X $2,125,800)	($708,600)
U.S. estate tax before marital credit	$37,200
Less: marital credit (limited to taxes payable)	($37,200)
U.S. estate tax after unified and marital credits	$0

Summary

There are many potential methods to minimize the U.S. estate tax liability. Common planning ideas include the following: setting up a "cross-border trust" to hold the U.S. real estate; financing the purchase of U.S. real estate with a "non-recourse mortgage", effectively reducing the net value of the total U.S. properties; and, reducing the value of the Canadian estate.

Owning a rental property in the U.S. can have significant U.S. income and estate tax implications. Speak with your cross-border tax advisor about your own tax situation, and before implementing any tax planning strategies.

This document is prepared by The Bank of Nova Scotia for the use of members of Scotia Wealth Management and their clients and may not be redistributed. It is for general information purposes only. Information herein was obtained from various sources believed to be reliable but is not guaranteed for its accuracy.
© Copyright 2016 The Bank of Nova Scotia. All rights reserved. This publication has been prepared by The Bank of Nova Scotia and is intended as a general source of information only and should not be considered as personal and/or specific financial, tax, pension, legal or investment advice. We are not tax or legal advisors and we recommend that individuals consult with their qualified advisors before taking any action based upon the information contained in this publication. Opinions and projections contained in this publication are our own as of the date hereof and are subject to change without notice. While care and attention has been taken to ensure the accuracy and reliability of the material in this publication, neither The Bank of Nova Scotia nor any of its affiliates make any representations or warranties, express or implied, as to the accuracy or completeness of such material and disclaim any liability resulting from any direct or consequential loss arising from any use of this publication or the information contained herein. This publication and all the information, opinions and conclusions contained herein are protected by copyright. This publication may not be reproduced in whole or in part without the prior express consent of The Bank of Nova Scotia.