Canadian Ownership of U.S. Real Property

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Many Canadians enjoy spending time in the U.S., and at some point may consider the purchase of a U.S. vacation property. As a result, it is important for Canadians to fully understand U.S. reporting and tax issues related to their ownership of U.S. real property, in addition to any Canadian tax implications.

This article briefly outlines the Canadian and U.S. income and estate tax implications for a Canadian resident (who is not a U.S. citizen or Green Card holder) who purchases U.S. real property as a vacation property, and includes a summary of potential ownership structures when considering such a purchase. A discussion of strategies related to the ownership of U.S. real property for the purposes of generating rental income is beyond the scope of this article; however, some U.S. income tax considerations with respect to earning rental income and the sale of the property are provided at the end.

U.S. estate tax

Unless the vacation property is transferred to a surviving spouse[1] (or qualifying spousal trust) at the time of death, a Canadian resident would generally incur Canadian income tax on the unrealized capital gains on the property, as a result of a deemed disposition, at fair market value, of the property at death. Note that this gain would be calculated in Canadian dollars, such that the actual capital gain or loss reported would include a foreign exchange component in addition to any change in the U.S. dollar value of the property over the period of ownership.

For U.S. tax purposes, the Canadian owner of U.S. real property may also be subject to U.S. estate tax on that property if the individual has U.S. situs assets in excess of US$60,000, and the value of their worldwide assets is in excess of the exclusion amount in the year of their death. U.S. tax reform that was signed in December 2017 increased the estate tax exclusion amount to US$10 million (from the previous exclusion amount of US$5 million). The inflation adjusted amount for 2022 is US$12.06 million. While the increased exemption may eliminate (or reduce) the U.S. estate tax exposure for many estates, it is important to note that the increased exclusion amount is only effective until the end of 2025, when it is scheduled to revert back to the inflation adjusted amount of US$5 million. U.S. situs assets include real property located in the U.S., stocks, options and mutual fund units issued by a U.S. entity. Instead of imposing tax on the unrealized gain, the U.S. will impose U.S. estate tax on the fair market value of the property at the time of death. However, there is some relief provided in the Canada/U.S. Income Tax Treaty which allows a credit against Canadian Federal income tax for U.S. estate tax payable on property that is located in the U.S. This credit can significantly reduce the Canadian income tax applicable to that property.

Structuring the ownership of U.S. real estate by Canadian residents

In order to address a potential U.S. estate tax liability, there are several ownership structures that a Canadian may consider for a U.S. residential property, including:

- Direct ownership;
- Ownership through a Canadian-resident trust;
- Ownership through a Canadian partnership; or
- Ownership through a Canadian corporation.

Direct ownership

There are several direct ownership structures:

i. Individual ownership

Ownership of a property by an individual allows for limited U.S. estate tax planning opportunities. U.S. estate tax may be reduced or eliminated by maximizing the credits and deductions available to an individual. If the individual is married or in a common-law relationship,, it may be beneficial to have the spouse with the lower net worth assume ownership of the property, particularly if the spouse has worldwide assets less than the applicable U.S. estate tax exemption amount (US$12.06 million for 2022). However, if any property is transferred between spouses, it will be important to consider the possible imposition of U.S. gift tax on the transfer, as well as the attribution rules that may be applicable for Canadian income tax purposes on any annual income or capital gain from the eventual sale of the property, which could impact the effectiveness of this strategy.

If the U.S. estate tax liability cannot be fully eliminated, life insurance could be considered to fund the residual U.S. estate tax liability.

ii. Joint tenancy with the right of survivorship

Ownership by a married couple jointly with right of survivorship is the simplest structure for the transfer of assets at death and is often used for probate tax planning. However, this ownership structure is generally not recommended for Canadian couples who own U.S. real estate as there is the potential that the full value of the U.S. property would be subject to U.S. estate tax twice: once when the first spouse dies; and again when the second spouse dies.

A married couple who own a property jointly with the right of survivorship may therefore want to consider severing their joint tenancy in favour of a tenancy in common structure based on the original contributions of each spouse. If the new ownership structure is not reflective of each spouse's contribution, then U.S. gift tax may be triggered. As previously mentioned, the Canadian attribution rules should also be considered upon any transfers between spouses.

iii. Tenancy in common

If each spouse wishes to own an interest in the property, a more favourable structure may be to own the property through a tenancy in common.

Under a tenancy in common structure, each spouse may have equal or unequal shares of interest in the property. In this structure, the deceased's share of the property passes to whoever is designated under their Will and not automatically to the surviving spouse. This strategy allows more flexibility for planning opportunities as each spouse may direct that their share of the property pass to a spousal trust. For example, each spouse can create a testamentary trust for each other so that the portion of the property that was owned by the first spouse to die is excluded from the estate of the surviving spouse. This can reduce or eliminate the U.S. estate tax on the death of the surviving spouse by reducing the value of the U.S. situs property and worldwide estate on the second death.

Another planning technique is to include a provision in the Will such that the property is transferred from the estate to a Qualifying Domestic Trust ("QDOT"). This could defer both the U.S. estate tax and Canadian income tax until the death of the surviving spouse. The QDOT does not eliminate the U.S. estate tax, it simply defers the timing of the estate tax. The deferral would allow the U.S. estate tax to be applicable at the same time as the Canadian income tax upon death of the surviving spouse, thereby allowing for the application of available foreign tax credits to reduce the Canadian tax from the deemed disposition at death.

Ownership through a Canadian resident trust

A properly structured Canadian discretionary inter-vivos trust provides another alternative whereby U.S. estate tax could be avoided. That's because upon death the property is owned by a trust (and not the individual) which is not subject to U.S. estate tax. In order to avoid exposure to U.S. estate tax the trust should directly purchase the property using funds provided by the individual who establishes the trust. Since the transfer of real property to an irrevocable trust would be considered a gift for U.S. gift tax purposes, it is important that the funds be transferred into the trust first, before the property is purchased.

One disadvantage of this ownership structure is that for Canadian income tax purposes, a Canadian resident trust is deemed to have disposed of all its capital property on the 21st anniversary of its creation date. As such, the structure only generally allows for a 21-year planning opportunity. It is also important to draft the terms of the trust agreement such that the gain on an eventual sale of the property is not attributed back to the settlor for Canadian income tax purposes, and to ensure the proper application of foreign tax credits to avoid double taxation.

Another drawback to consider is that an individual who acquires U.S. real estate using a trust should be prepared to give up both ownership and control of the real estate to the trust. The person funding the trust cannot be a beneficiary or the trustee of the trust. As such, common planning involves naming a spouse as the main beneficiary of the trust. The individual who settled the trust would only be able to use the property as the spouse of the beneficiary of the trust, or on a rental basis after the death of the spouse beneficiary.

Ownership through a Canadian corporation

In the last decade, the use of a single purpose Canadian holding company to purchase a U.S. vacation property has not been an attractive ownership strategy to minimize U.S. estate tax exposure. The Canada Revenue Agency (the "CRA") will assess shareholders for a taxable benefit with respect to their personal use of a vacation property owned by their corporation (unless the corporation was established before 2005). In addition, the applicable Federal rate for U.S. income tax purposes on capital gains realized on the sale of a property may have been much higher for a corporation (35 per cent prior to 2018) than for a trust or an individual (maximum rate of 20 per cent). For these reasons, this structure has not generally been recommended. However, the recent reduction in the U.S. corporate income tax rate from 35 to 21 per cent has made this ownership structure more attractive than in prior years.

Ownership through a Canadian partnership

It may be possible for U.S. estate tax to be minimized if U.S. real property is held by a Canadian partnership which makes an election to be treated as a corporation in the U.S. for U.S. tax purposes. However, it should be noted that ownership of U.S. real property through a Canadian partnership is one of the most complicated alternatives for holding property and involves some uncertainty around the tax implications, as the Internal Revenue Service ("IRS") has not provided any definitive guidance on the tax implications for this particular structure.

Non-recourse mortgage

Another alternative that may be considered is to obtain a non-recourse mortgage on your U.S. real property. This type of mortgage reduces the value of U.S. situs property on a dollar for dollar basis. The borrower, under a non-recourse mortgage, has no personal liability and the lender can only look to the real property to enforce payment. As a result, this type of funding may be difficult to obtain from a commercial lender.

Other U.S. income tax considerations

Property rental

If you decide to rent out your U.S. real property, there are additional complexities. For example, a tenant who pays rent to a Canadian owner of a U.S. property is required to withhold a 30 per cent withholding tax on gross rents unless the property owner elects to treat the rent as "effectively connected income."

An election to treat the income as effectively connected income may allow for the following:

- No withholding would be required if a Form W-8-ECI is provided to the individual who is paying the rent;
- The Canadian property owner may be able to claim certain deductions such as depreciation, maintenance costs and property taxes. Some restrictions may apply if the property is used for personal purposes in addition to generating rental income;
- The net rental income would be subject to graduated U.S. individual income tax rates;
- A U.S. individual income tax return (Form 1040NR) would need to be filed by the owner to report the rental income or loss; and
- For Canadian income tax purposes the rental income should also be reported. However, a foreign tax credit may be claimed for the U.S. income tax paid on the rental income to offset some of the Canadian income tax on the same income.

In addition, there may be a requirement to include a Foreign Income Verification Statement (T1135) with your Canadian income tax return.

Sale of U.S. real property

Withholding tax

Upon the ultimate sale of your U.S. real estate property there are several important U.S. and Canadian tax implications. While there are certain exceptions (such as when the buyer will use the property as a principal residence and the proceeds are not more than US$300,000) under the Foreign Investment in Real Property Tax Act ("FIRPTA"), and an individual who buys U.S. real estate from a seller who is not a U.S. citizen or resident is generally required to withhold 15 per cent of the purchase price and remit that amount to the IRS as an instalment towards the seller's ultimate U.S. tax liability on the sale.

In order to decrease or eliminate the withholding amount, a Canadian seller may obtain an IRS withholding certificate; ideally before the transfer of property. A seller that has applied for a withholding certificate must notify the buyer in writing that the certificate has been applied for on the day of, or prior to the transfer of property. The IRS will normally act on an application for a withholding certificate within 90 days of receipt of all information necessary to make a proper determination. If a certificate is issued before the transfer of property, the withholding amount may be decreased or eliminated. Any withholding tax on the certificate would be based on the amount of U.S. income tax that would actually arise from the gain on the sale of the property rather than simply 15 per cent of the sale proceeds. If a withholding certificate is issued after the transfer of property, the IRS may authorize an early refund of any excess withholding tax.

The gain or loss on the sale of U.S. real property by a non-U.S. person is required to be reported on a U.S. individual non-resident income tax return. A state income tax return may also be required, depending on the state's income tax regime. When the individual files the tax return they must pay additional tax if the withholding tax did not sufficiently cover the taxes, or claim a refund if the withholding tax was in excess of the actual U.S. tax liability. Therefore, Canadians who own U.S. real property should maintain complete records of the property purchase and any capital improvements so that the U.S. tax cost can easily be determined at the time of sale.

In addition to the U.S. reporting requirements, a Canadian who sells U.S. real property must report the gain for Canadian income tax purposes. As with the case of U.S. taxes paid on rental income, any U.S. income tax paid on the gain from the sale of the property may be claimed as a foreign tax credit to offset Canadian income tax payable on the gain from the sale. The gain for Canadian income tax purposes would be calculated in Canadian dollars such that the actual capital gain or loss reported would include a foreign exchange component, in addition to any change in the U.S. dollar value of the property.

Conclusion

While this article places more emphasis on the U.S. income and estate tax considerations of owning a U.S. vacation property, Canadian residents should weigh the results from any planning for U.S. income and estate tax against the impact on their Canadian income tax. Ultimately, the most appropriate planning strategy that minimizes their overall tax liability encompassing both jurisdictions should be determined.

In addition to tax considerations, legal and other concerns such as the administrative complexity and burden of maintaining a certain structure, the costs (such as professional fees) of implementing and maintaining a structure, and the intentions of the individual with respect to the property should be evaluated before making a final decision on an ownership structure. Finally, given the complexity and the need to coordinate the tax implications in both jurisdictions, it is very important that Canadian individuals seek the advice of a cross-border estate tax professional before the purchase of a U.S. property to ensure the proper analysis and implementation of any tax planning strategy.

For more information, please speak with your BMO financial professional.

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[1] For ease of reference, spouse and common-law partner will be referred to as "spouse" in this article.

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