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Your U.S. vacation property could be quite taxing

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It seems everywhere we look, Canadians are snapping up U.S. vacation properties. Though your vacation property may be located beyond Canada's borders, that doesn't mean that it is outside the reach of the tax authorities.

There are certain events that may trigger taxes on a vacation property. If you rent your property to others, you may pay tax on the rental income that you earn. And if you sell or gift the property during your lifetime or if you own real estate upon your death, tax could also be payable.

If you are a Canadian resident who owns a U.S. vacation property, taxation becomes more complex because you will have to consider both Canadian and U.S. taxes at each of these stages. With proper planning, however, you can minimize the impact of taxes on your vacation home so that you and your family members can enjoy it for years to come.

Let's take a look at some U.S. and Canadian tax considerations for Canadians who own a U.S. vacation home.

Tax tips for your U.S. vacation property:

1. Although income and capital gains may be taxed in both the U.S. and Canada, you can generally claim a foreign tax credit to reduce Canadian tax.
2. When you dispose of your U.S. vacation home and owned another home during the same time, consider which property should benefit from the principal residence exemption.
3. Gifting a U.S. vacation property is generally not recommended, since it could result in a significant tax bill in both the U.S. and Canada.
4. Consider whether to implement strategies to reduce or eliminate U.S. estate tax that may apply if you own your U.S. vacation home upon death.
5. Consult with Canadian and U.S. tax advisors, preferably prior to purchasing U.S. real estate.

Rental income

If you are like many vacation property owners, chances are that you rent or at least try to rent your property when you are not occupying it. If so, the rental income that you earn may be taxed in both the U.S. and Canada.

U.S. taxation

For U.S. tax purposes, a 30% U.S. withholding tax applies to gross rental income that you earn from your U.S. property. The tenant of your property is required to withhold the tax and remit it to the U.S. tax authorities on your behalf. You may, however, elect to have the income treated as income from a U.S. business so that the U.S. withholding tax would not apply.

If you make this election, you must report your U.S. rental income on an annual U.S. income tax return but will be allowed to deduct applicable expenses. The net rental income will be taxed at graduated U.S. federal tax rates. State income taxes may also apply to rental income.[1]

Canadian taxation

In Canada, you will pay tax at graduated federal / provincial tax rates on worldwide income, including net rental income from your U.S. property after deducting applicable expenses. You can generally claim a foreign tax credit on your Canadian tax return for the U.S. income taxes that have been paid, to reduce the tax that will be payable in Canada.

Selling your U.S. vacation property

In both Canada and the U.S., there may be tax on the capital gain when you sell your U.S. vacation property. A capital gain arises if the proceeds from disposition, net of selling expenses, exceed the cost of the property. Amounts paid for capital improvements to the property may generally be added to the cost of the property, thus reducing the capital gain, so you should hold onto your receipts to validate these amounts.

U.S. taxation

In the U.S., the maximum federal long-term capital gains tax rate is 20% and individuals who are subject to low marginal tax rates may pay a lower rate on capital gains. You would pay the long-term capital gains tax rate provided you owned the property for more than one year prior to sale. If you owned the property for one year or less graduated U.S. federal income tax rates (with a top rate of 37%) would apply to short-term capital gains. State taxes may also apply.[2]

In the U.S., the purchaser is generally required to withhold 15% of the gross proceeds when the seller is Canadian. (If the purchaser acquires property for use as a residence, no withholding is required when the proceeds of sale are under US$300,000, and a 10% rate applies for proceeds up to US$1 million). You may apply to the IRS for a withholding certificate that would allow withholding taxes to be reduced or eliminated, such as when the ultimate income tax liability is expected to be less than the withholding amount. You may generally claim the withholding tax as a credit against any tax owing when you file a U.S. tax return.

Canadian taxation

When disposing of your U.S. property, if you sell it for a profit, 50% of the capital gain is included in taxable income in Canada. Any capital gain or loss must be calculated in Canadian currency. That is, the cost of the property must be converted into Canadian dollars at the prevailing exchange rate at the time the property was purchased. Similarly the proceeds of disposition is the Canadian dollar equivalent at the time of sale. You may be able to claim the principal residence exemption (PRE) to reduce or eliminate the taxable capital gain. Each family unit (spouses or common-law partners and their minor children are considered to be one family unit) may claim the PRE for one home, including a U.S. vacation home. If you have more than one home during a year, you will have to decide which should benefit from the PRE. If you claim the PRE for all years of ownership, there will be no taxable capital gains on the property.

You must report the disposition on Schedule 3 of your *T1 Individual Income Tax Return* to claim the PRE. You will not be able to claim the PRE if you have deducted depreciation in calculating net rental income from the property.

In Canada, any taxable capital gain from your U.S. vacation property, after claiming the PRE, is taxed at graduated federal and provincial tax rates. A foreign tax credit is generally available for tax paid on capital gains in the U.S. to reduce the amount of Canadian tax that you will pay. Since the foreign tax credit is not refundable, you will

not be able to recoup U.S. taxes that exceed your Canadian tax liability. As such, if you have a U.S. tax liability, you may want to consider preserving the PRE for another property that you owned at the same time as your U.S. vacation home.

Gifting your U.S. vacation property

Rather than selling, suppose you want to gift your vacation home, perhaps to your spouse, children or grandchildren, to keep it in the family for future generations. Unfortunately, your generosity may have a significant tax bill attached. Generally, gifting a U.S. vacation property is not recommended due to the U.S. gift tax regime and special Canadian tax rules, which could result in a significant tax bill in both countries.

U.S. taxation

Gifts of U.S. real estate are subject to U.S. federal gift tax.[3] A minor exclusion from federal gift tax[4] of US$15,000 per recipient is available; however, the remainder of the fair market value of the property would be subject to U.S. gift tax. If you gift property to an individual who is more than one generation younger than you, such as your grandchild, U.S. federal generation-skipping transfer (GST) tax may be added to your tax bill.

Since the gift tax and GST tax can be significant, gifts of U.S. property are generally not advisable. If you do make a gift of property, the recipient of the gift (such as your spouse, child or grandchild) may ultimately pay tax in the U.S. on capital gains when the property is sold.

Canadian taxation

In Canada, if you transfer your vacation home at less than FMV to your spouse or common-law partner, there generally are no immediate tax consequences; however, you will usually still pay tax on the capital gain when the property is ultimately sold. If the transfer is made to a non-arm's length individual who is not your spouse, such as your child, the transfer will be deemed to occur at fair market value and you will realize a capital gain upon transfer.

Unfortunately, no foreign tax credit against Canadian capital gains tax, if applicable, is available for U.S. gift tax or GST tax that has been paid.

Combined taxes

Due to the differences in the Canadian and U.S. tax systems, double taxation often occurs with a gift of a U.S. vacation property. For example, if you gift the property to your spouse, you will pay U.S. gift tax at the time of the gift.[5] If there is a capital gain when the property is later sold, your spouse will pay tax in the U.S. on the capital gain accrued from the time of the gift. At the same time, you will pay tax in Canada upon the sale of the same property on the capital gain accrued from the time the property was purchased. Since no foreign tax credit can be claimed for either your U.S. gift tax or your spouse's U.S. tax on the capital gain, tax is payable in both countries with no relief.

When considering gifts of U.S. real estate, consulting with Canadian and U.S. tax professionals is imperative to avoid costly pitfalls.

Estate considerations

If you die owning your U.S. vacation property, you could pay tax in Canada and/or the U.S.

U.S. taxation

The U.S. has a federal estate tax that may be levied on the fair market value of your U.S. vacation home if you own it upon your death.[6] In addition, about a third of U.S. states have their own estate and/or inheritance taxes.

There is a federal estate tax exemption that may eliminate your federal estate tax bill if the value of your worldwide estate, including your U.S. vacation home, is under US$11.2 million in 2018.[7] Married Canadians may also be able to access the

marital credit under the Canada-U.S. tax treaty, which may effectively eliminate federal estate tax if the value of the estate does not exceed US$11.2 million.[8]

If the value of your worldwide estate exceeds US$11.2 million (US$22.4 million if you leave all your property to your surviving Canadian resident spouse), you may have to pay U.S. federal estate tax. You may, however, be able to eliminate the federal tax liability altogether with some advance planning using some common strategies.

One solution is to gift some of your assets during your lifetime, to reduce the value of your estate below the threshold for U.S. estate tax. If the value of your worldwide estate can be kept below US$11.2 million (or US$22.4 million if you leave all your property to your surviving Canadian resident spouse), you may be able to claim the full U.S. estate tax exemption and avoid a U.S. federal estate tax bill altogether. Remember, however, that gifting certain U.S. assets may result in U.S. gift tax or immediate tax in Canada on capital gains and the recipient of such gifts would have exposure to U.S. estate tax if the asset is held at death.

Another strategy is to purchase life insurance to cover any tax liability upon death. Keep in mind that the value of such life insurance will generally be included in the value of your worldwide estate when calculating U.S. estate tax.

Another solution is "non-recourse" debt, which can reduce the value of the property for U.S. federal estate tax purposes. This is a mortgage in which the lender only has the ability to collect amounts owing from the sale of the property, as opposed to the general assets of the borrower. Given recent events, such debt may be hard to find.

Years ago, U.S. real estate was often purchased through a Canadian corporation to avoid U.S. taxes, but the Canada Revenue Agency now imposes a taxable benefit upon the corporation's owner for any personal use of the property, making this strategy less worthwhile. That's why many cross border tax professionals are recommending establishing a trust to own the U.S. property.

When purchasing the property, you may want to consider ownership options. Two common options are to own the property as joint tenants with right of survivorship (JTWROS) or tenants in common (TC). With JTWROS, your interest in the property will pass to the other owner(s) upon your death; however, unless there is evidence that the other owner(s) contributed to the purchase price, the full value of the property will be subject to the U.S. estate tax when you die. With TC, your interest in the property will pass to your heirs upon your death and only your share of the property will be subject to estate tax.

It can be difficult to do any planning after the purchase of the property without triggering taxes; therefore, it is best to consider these strategies before purchasing a property. Be sure to get expert advice before proceeding.

Canadian taxation

For Canadian tax purposes, you are deemed to dispose of your U.S. vacation property upon death, which could result in a taxable capital gain. As with a sale of property during your lifetime, the PRE may be claimed to reduce or eliminate tax on your home. If you do still have a taxable capital gain from your U.S. vacation property upon your death, a foreign tax credit may be claimed, thereby reducing the tax that you pay on capital gains in Canada.

A final note

This article has explored some of the primary Canadian and U.S. tax considerations for owning real estate in the United States; however, it is not comprehensive. Since the taxation issues are complex, you should consult with Canadian and U.S. tax advisors, preferably before purchasing a property. Your advisors can help you to determine the tax implications and potential strategies for making ownership of your dream U.S. vacation home a less taxing reality.

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[1] Note that certain U.S. States, such as Florida, do not levy income tax on individuals.

[2] Ibid.

[3] In 2018, U.S. gift tax is imposed at graduated rates ranging from 18% to 40% of the fair market value of the gift.

[4] In 2018, the exclusion allowed for a non-resident of the U.S. is generally US$15,000 per recipient (US$152,000 for gifts to a spouse who is not a U.S. citizen). The exclusion is indexed annually for inflation.

[5] Gift tax will apply to the extent that the fair market value of the gift exceeds the gift tax exclusion amount.

[6] In 2018, U.S. federal estate tax is imposed on the FMV of assets at graduated rates ranging from 18% to 40%.

[7] The *Tax Cuts and Jobs Act*, which became effective on January 1, 2018, effectively doubles the U.S. estate tax exemption for deaths between 2018 through 2025. After that time, unless permanent legislation is enacted, the exemption will return to the pre-2018 regime in 2026.

In 2018, there is a federal estate tax exemption of US$11.2 million based on the maximum unified credit, which is indexed annually for inflation. The full exemption amount is generally not available for Canadian residents and is pro-rated under the Canada-U.S. tax treaty for Canadian residents holding U.S. situs assets at death. The available exemption is equal to the US$11.2 million exemption multiplied by the ratio of U.S. situs property, including U.S. real estate, to the worldwide estate. Thus, if your worldwide estate, including your U.S. vacation home, is under US$11.2 million there likely will be no federal estate tax if you were to die in 2018.

[8] A married individual who leaves U.S. situs assets, including U.S. real estate, to a surviving spouse may claim a marital credit under the Canada-U.S. tax treaty. The maximum marital credit is equal to the unified credit that is allowed. Since the unified credit can exempt estates up to US$11.2 million from U.S. estate tax in 2018, claiming both the maximum unified and marital credits would essentially double the federal estate tax exemption. This means that a worldwide estate up to US$22.4 million in 2018 may be sheltered from federal estate tax if bequeathed to a surviving spouse. The marital credit is not available if the decedent is not survived by a spouse.

Disclaimer:

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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