Rental and sale of U.S. real estate

The economic landscape in the U.S. has made it very attractive for Canadians to purchase vacation or rental properties in the warmer climates. Interest has increased as result of much lower pricing as well as the stronger Canadian currency with anticipation of realizing significant capital gains when the market recovers.

The U.S. like Canada, have specific tax rules with respect to the ownership of real estate by non-U.S. persons. Often the simple things to be in compliance are not provided to the investor as part of the marketing process, causing unnecessary grief for the unwary.

U.S. RENTALS

Withholding tax
Canadians who intend to rent their vacation home or secondary residence situated in the U.S. are subject to a U.S. withholding tax of 30% on the gross rental. The agent who collects the rent is responsible to remit the tax to the IRS.

The agent should tell you that you need to apply for an individual taxpayer's identification number ("ITIN"). This number is noted on the tax information slip reporting the gross rental to the IRS.

Waiver of withholding tax
Under U.S. rules, a waiver from withholding on the gross rental is available by providing the agent with IRS Form W8-ECI every 3 years. The W8-ECI requires the ITIN. Until a properly completed W8-ECI is accepted by the agent, the agent may still withhold.

Ultimately, mechanics of taxation determine the real dollars earned from your investment...

The completion of the W8-ECI obligates the owner to file an annual tax return (due June 15th for individual owners), reporting net rental income and pay U.S. tax on the net. Net real income is gross rent less expenses less U.S. depreciation on the building and on furniture & fixtures.

Filing tax returns
Without the waiver, you may still elect to file a tax return and claim credit for any tax withheld. The election covers all rental properties. Once you elect, it is binding until you revoke the election.

Filing the return on a timely basis will allow you to utilize accumulated losses against net rental income and on gains from the sale of the property.

Filing will also allow you to properly claim credit for U.S. tax on your Canadian tax return.

With joint ownership or tenants in common, each party must complete their own W-7 and tax returns.

W-7 applications
TheW-7 requires a copy of your passport that is notarized by the Canadian passport office or by a U.S. notary. A faster approach is to engage an IRS Acceptance Agent practicing in your area to prepare a Certificate of Accuracy. With this procedure, it usually takes about 6-8 weeks to obtain the ITIN.

U.S. REAL ESTATE SALES

Capital gains realized on the sale of any U.S. real property interest will attract Canadian and U.S. tax. Canada will generally provide a foreign tax credit for the U.S. federal and state tax.

Withholding tax
If the sale price is under $300,000US and the property is acquired as a principal residence by the purchaser, the 10% federal withholding tax on gross proceeds is waived. The purchaser must sign an affidavit to confirm this. Specific regulations define the meaning of "principal residence" for purposes of this withholding exemption.

The 10% withholding tax must be remitted within 20 days of the date of closing with IRS Form 8288. A stamped copy of 8288-A will be mailed to you to claim credit on your tax return. If you never rented the property, you should apply for the ITIN by your closing date.

Ultimate tax liability
For properties held over a year, the maximum federal tax rate is 15% for sales before 2013. The tax rate is expected to increase to 20% after 2012.

Reduced withholding
Tax returns may not be filed until the year following the year of sale, delaying your refund.

You may apply for a lesser amount of withholding tax if you believe the 10% rate will be in excess of your actual tax liability. This application should be considered if there is a mortgage or a line of credit on the property and the 10% will have to come out of your pocket.

You may apply for a reduced withholding by filing an application for a withholding certificate on IRS Form 8288-B. You will need an ITIN to properly file this form. Once approved, the IRS will notify your lawyer to remit the required amount of tax held within 20 days. The IRS must act within 90 days to process the 8288-B.

STATE ISSUES

Whether or not you file the W8-ECI or a tax return, some states will require the filing of a state non-resident return reporting the net rental and the sale. Most states do not withhold tax on a real estate sale.

Alternative ownership structures

Where real estate interests are held through a U.S. partnership, estate/trust or corporation, similar rules apply with respect to rentals and sales. Distributions from these entities may attract a 35% withholding tax.

For corporate owners, an employer's identification number ("EIN") is required in lieu of the ITIN. The EIN may be obtained by simply calling the IRS. The EIN is noted on the W8-ECI and 8288-B in lieu of the ITIN.

For large dollar purchases, investors should also consider the U.S. federal estate tax rules in determining the appropriate method of ownership. Effective estate tax rates are scheduled to increase in 2013.

COMPLIANCE IS SIMPLE!

Although U.S. tax compliance is an added administrative cost of investing in U.S. real estate, it does not have to be complicated.

By not filing returns or avoiding the 30% withholding tax without a valid W8-ECI, you lose the ability to utilize losses and create unnecessary risk when you endeavor to complete the sale of your interest.

Properly completed tax returns should generally provide for full credit for U.S. taxes on your Canadian returns without the incidence of double taxation.■

Larry Stolberg CA, CPA, CFP

U.S. forms are available on the IRS website (at http://www.irs.ustreas.gov/pub).

Contact your professional advisor prior to implementing any of the outlined strategies

Internal Revenue Service Circular 230 Disclosure
Pursuant to Internal Revenue Service Circular 230, we hereby inform you that the advice set forth herein with respect to U.S. federal tax issues was not intended or written to be used, and cannot be used, by you or any taxpayer, for the purpose of avoiding any penalties that may be imposed on you or any other person under the Internal Revenue Code.