

# ESTATES & TRUSTS LEGALNEWS

## OWNING A VACATION HOME IN THE U.S.: CROSS BORDER PLANNING

### Introduction

Due to the "financial crisis" in U.S. real estate and the relative strength of the Canadian dollar in the past couple of years, an increasing number of Canadians are purchasing a second home or vacation property in the U.S. However, unless properly structured, the ownership and disposition of a U.S. property can be fraught with complications for the misinformed and ill prepared.

### Joint Tenancy and your U.S. vacation home

Joint ownership, as a general rule<sup>1</sup>, is not a recommended form of ownership for Canadian residents who have decided to purchase real property in the U.S. as this form of ownership can create U.S. gift and estate tax problems. For example, U.S. gift tax may be imposed on the creation or termination of the joint tenancy. In addition, 100% of the value of the property is included in the estate of a deceased joint tenant if the surviving joint tenant is not a U.S. citizen; unless the executor of the estate can prove that the surviving joint tenant contributed funds towards the purchase of the property.

Furthermore, for Canadian tax purposes, a deemed disposition occurs on the death of the surviving joint tenant that can result in foreign tax credit problems.

### Renting your U.S. vacation home

A Canadian resident who decides to rent a U.S. vacation property is subject to U.S. tax on their gross rental income and Canadian tax on their net rental income.

#### (a) U.S. tax consequences

The rents that are received are subject to a 30% withholding tax, which tenants are required to deduct and remit to the Internal Revenue Service (IRS), even if the tenants are Canadians or other non-residents of the U.S. This is a flat rate of tax charged on the gross rents. However, if there are expenses associated with renting out the U.S. property (such as interest, property taxes, utilities, condominium fees, rental agent and cleaning fees), the client can elect to be taxed on the net rental income at graduated tax rates, rather than the 30% flat rate on the gross rent. In many cases, the tax on the net rent will be much less than the tax on the gross rent. Making this election will require the client to file a U.S. tax return, on a timely basis, for each year the property is rented. Taxes withheld and remitted on the gross rent will



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[Estate Planning & Administration Attorneys](#)

#### Dickinson Wright LLP

Steven J. Gray, Toronto  
416-777-4032 • [sgray@dickinsonwright.com](mailto:sgray@dickinsonwright.com)

Kathleen A. Strachan, Toronto  
416-777-2394 • [kstrachan@dickinsonwright.com](mailto:kstrachan@dickinsonwright.com)

#### Dickinson Wright PLLC

Kevin M. Bernys, Troy  
248-433-7234 • [kbernys@dickinsonwright.com](mailto:kbernys@dickinsonwright.com)

Deborah L. Grace, Troy  
248-433-7217 • [dgrace@dickinsonwright.com](mailto:dgrace@dickinsonwright.com)

Henry M. Grix, Troy  
248-433-7548 • [hgrix@dickinsonwright.com](mailto:hgrix@dickinsonwright.com)

Thomas D. Hammerschmidt, Jr., Ann Arbor  
734-623-1602 • [thammerschmidt@dickinsonwright.com](mailto:thammerschmidt@dickinsonwright.com)

Judith Fertel Layne, Troy  
248-433-7563 • [jlayne@dickinsonwright.com](mailto:jlayne@dickinsonwright.com)

Ralph Levy, Jr., Nashville  
615-620-1733 • [rlevy@dickinsonwright.com](mailto:rlevy@dickinsonwright.com)

Leslee M. Lewis, Grand Rapids  
616-336-1042 • [llewis@dickinsonwright.com](mailto:llewis@dickinsonwright.com)

Douglas L. Mann, Troy  
248-433-7244 • [dmann@dickinsonwright.com](mailto:dmann@dickinsonwright.com)

Ward Randol, Jr., Troy  
248-433-7233 • [wrandel@dickinsonwright.com](mailto:wrandel@dickinsonwright.com)

Joan Cripe Skrzyniarz, Troy  
248-433-7521 • [jcripe@dickinsonwright.com](mailto:jcripe@dickinsonwright.com)

James P. Spica, Detroit  
313-223-3090 • [jspica@dickinsonwright.com](mailto:jspica@dickinsonwright.com)

Cynthia J. Black Svenson, Troy  
248-433-7530 • [cvsenson@dickinsonwright.com](mailto:cvsenson@dickinsonwright.com)

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be applied to their net U.S. tax liability, and if the net tax is less than the taxes withheld, the client will be able to get a refund of the excess.

Depending on the state where the property is located, the client may also need to report the rental income earned to the state. For example, Florida does not levy state income tax, and neither does Texas, but both Arizona and California do.

## (b) Canadian tax consequences

As a Canadian resident, the client must also report the gross rent received from renting a U.S. vacation property, and then certain qualifying expenses can be deducted in Canada. For example, if there is a net profit in Canada, and Canadian tax owing on the U.S. rental income, the client can apply the U.S. federal and state taxes on the rental property as a tax credit to reduce Canadian taxes. If there is U.S. tax but no Canadian tax (due to differences in the two countries' tax systems), the U.S. tax can be deducted as an expense, rather than taken as a tax credit.

## Selling your U.S. vacation home

A Canadian resident that owns a home in the U.S. must report the sale of the property for both Canadian and U.S. income tax purposes even if there was no gain on the sale of the property, and even if the property was held for personal use and was not rented out.

Before selling their U.S. property, the client should obtain advice as to whether there will be U.S. withholding tax on the sale. U.S. law requires withholding at a current rate of 10% of the gross sales price where a non-resident of the U.S. sells real property. However, there is an exemption from withholding if the property is sold for \$300,000 U.S. or less and the purchaser intends to use the property as a residence. In order to meet the "use as a residence test", the purchaser must have definite plans to reside in the property in accordance with the IRS rules.

## Death and your U.S. vacation home

On death, a Canadian resident that owns a home in the U.S. will pay Canadian income tax on the accrued capital gain on their U.S. vacation home and will also be subject to U.S. estate tax on the value of their home. Due to the fact that Canadian capital gains rates are significantly lower than the top U.S. estate tax rate and Canadian tax applies only to the gain in the property rather than its fair market value, the estate will likely pay tax at the U.S. estate tax rate - currently at 35% until the end of 2012.

Canada will provide the deceased's estate with a foreign tax credit, when the return is filed, for the U.S. estate tax paid on the U.S. home.

However, Canadian provinces generally do not allow a foreign tax credit for U.S. estate tax paid. As a result, the deceased may be subject to some double taxation at the provincial level.

## Conclusion

While this newsletter aims to highlight a number of tax issues that may arise in respect of Canadian residents owing a U.S. situs property, it is not intended to contain an exhaustive explanation of all of the issues that could arise. A client should seek the advice of experienced cross border professionals prior to the purchase of a U.S. vacation home, in order to avoid the potential trips and traps that can be associated with owning a home south of the border.

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<sup>1</sup> Additional issues are involved with respect to U.S. real property owned or proposed to be owned by married couples