

Tax Implications of Renting US Property

Excerpt from: South of 49 by Philip McKernan, Dan Sampson, and Mike Cunning

Many Canadians own US recreational property near border states. Retired Canadians who are seasonal residents of the US, or "Snowbirds," frequently own property in the US.

If either of the above situations applies to you, you may be renting out your US property on a part-time or full-time basis when you are not using it. If so, you are considered a "non-resident alien" by the IRS (the US Internal Revenue Service) and you are subject to US income tax on the rental income.

Tax on Gross Rental Income

The rent you receive is subject to a 30% withholding tax, which your tenant or property management agent is required to deduct and remit to IRS. It doesn't matter if the tenants are Canadians or other non-residents of the US, or if it was paid to you while you were in Canada. The Canada-US tax treaty allows the US to tax income from real estate with no reduction in the general withholding rate. As rental income is not considered to be effectively connected, it is subject to a flat 30% tax on gross income, with no expenses or deductions allowed. The 30% withholding tax would therefore equal the flat tax rate.

Tax on Net Rental Income

Since a tax rate of 30% of gross income is high, you may prefer to elect to pay tax on net income, after all deductible expenses. This would result in reduced tax payable and perhaps none at all. The Internal Revenue Code permits this option, if you choose to permanently treat rental income as income that is effectively connected with the conduct of a US trade or business. You would then be able to claim expenses related to owning and operating a rental property during the rental period, such as mortgage interest, property tax, utilities, insurance and maintenance.

You can also deduct an amount for depreciation on the building. However, the IRS only permits individuals (rather than corporations) to deduct the mortgage or loan interest relating to the rental property if the debt is secured by the rental property or other business property. If you borrow the funds in Canada, secured by your Canadian assets, you would not technically be able to deduct that interest on your US tax return. Obtain strategic tax planning advice on this issue.

Once you have made the election, it is valid for all subsequent years, unless approval to revoke it is requested and received from the IRS. However, you do need to file an annual return.

If you want to exempt from the non-resident withholding tax and are making that election, you have to give your tenant or property management agent a Form 4224, Exemption from Withholding Tax on Income Effectively Connected with the Conduct of a Trade or Business in the US. Contact the IRS for further information.

When you file your annual return, show the income and expenses, as well as the tax withheld. If you end up with a loss after deducting expenses from income, you are entitled to a refund of the taxes withheld. The due date of your return is June 15th of the following year.

It is important to file on a timely basis. If you fail to file on the due date, you have 16 months thereafter to do so. If you don't do so, you will be subject to tax on the gross income basis for that year, that is, 30% of gross rents with no deduction for any expenses incurred, even if you made the net income election in a previous year. This is an important caution to keep in mind. Many people don't arrange to have tax withheld at source, or file any US tax forms, on the premise that their expenses exceed the rental income and the net income election is always available.

Filing Requirements

You are required to report the gain or loss on sale by filing a Form 1040 NR, US Non-Resident Alien Income Tax Return. You would have to pay US federal tax on any gain (capital gain), and if you own the real estate jointly with another person, such as your spouse, each of you have to file the above form. For more information, contact the IRS.

In addition, you would have to report any capital gain on the sale of your US property in your next annual personal tax return filing with Revenue Canada. Remember, you have to report your worldwide income and gains and pay tax on 75% of any capital gain, converted to the equivalent in Canadian dollars, at the time of sale.

Since tax laws, regulations and filing forms can change at any time, make sure you speak to a professional accountant who is skilled in US tax matters.