

Tax Strategies for Canadian Investment in U.S. Real Estate by Tom Wheelwright

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

While it's important to understand the tax rules for investing in U.S. real estate, it's even more important to develop a strategy that minimizes your taxes on your U.S. investment income. A tax strategy is simply a comprehensive plan to reduce or eliminate the taxes on your U.S. property investments.

There are two primary principles we recommend for Canadians investing in the U.S. The first is to avoid personal identification by the IRS. This means, don't get a U.S. taxpayer identification number or social security number if you can help it. Instead, set up a corporation in the U.S. to do your investing. The IRS has very long arms and once you get in the IRS system, you will have a difficult time getting out.

Second, set up your investments so you only pay one tax, i.e. either the U.S. tax or the Canadian tax, but not both. You will be taxed in Canada on the income you earn in the U.S. You will also be taxed in the U.S. The key, then, is the foreign tax credit you take in Canada for income earned in the U.S. The secret to ensuring you receive this credit is to make sure that the "taxpayer" (i.e. entity) in Canada is the same taxpayer as the one paying the tax in the U.S. So, if you are paying taxes in the U.S. through a corporation, you want to make sure that corporation is the entity that pays tax in both the U.S. and Canada. There are some entities, notably limited liability companies that are taxed differently in the U.S. and in Canada. As a result, you could end up paying tax in the U.S. and paying tax in Canada as well.

The other key, of course, to minimizing your tax liability is to understand the U.S. and Canadian tax rules for real estate. Both countries allow a deduction for depreciation, only at different rates. And both countries allow a cost segregation analysis to speed up the depreciation. Depreciation is a non-cash deduction the government gives you for wear and tear on the property. Different types of property (e.g., building and contents) are depreciated at different rates. A cost segregation works to shift some of the cost of the property from the building to the faster-depreciated contents. You will need a qualified cost segregation expert (either accountant or engineer or both) to perform the cost segregation. On commercial properties, cost segregation can result in hundreds of thousands of dollars in tax savings.

There are other rules that you also need to know in the U.S., such as the passive loss rules, the 1031/like-kind exchange rules and the general rules for business and investment deductions and taxation. So our final recommendation is to hire a qualified Chartered Accountant in Canada who understands real estate and cross-border issues and a qualified Certified Public Accountant in the U.S. who specializes in these issues.

The good news is that with proper planning, a good tax strategy and the right advisors, you can seriously reduce and in some cases even eliminate the tax on real estate investment income.