The U.S.TAXFAX

TOPIC: NON RESIDENTS INVESTING IN U.S. REAL ESTATE

Date of Issue: July of 1996

This edition of the U.S.TAXFAX deals with the taxation of U.S. real estate owned by nonresident aliens of the United States (e.g. Canadian residents who are not U.S. citizens).

A. Purchase of U.S. Real Estate

Two common methods used by Canadians to purchase U.S. real estate is to purchase it directly or invest in a partnership interest. If the property is rented in any way there are U.S. tax compliance requirements which need to be addressed on an annual basis. The U.S. offers two methods of taxation with respect to rental activities by nonresidents.

1. Taxation of gross rents:

Real property rentals are subject to a 30% U.S. withholding tax at source. The tax must be withheld from rents by the payor (withholding agent) and deposited with the IRS on a periodic basis. The withholding agent is required to file an annual income tax return, Form 1042, with the IRS and must provide the payee with Form 1042S indicating the amount of taxes withheld. The withholding agent must file these forms by March 15 for the preceding calendar year.

If 30% of the gross rents were not withheld at source, the nonresident must remit the correct withholding by filing an income tax return.

Ordinarily, Canadian residents do not choose the gross method of taxation because rents are reported in Canada on a net basis. In Canada, after deducting allowable expenses, net rental income is generally break-even or in a loss position. If U.S. rental operations do not produce taxable income on the Canadian return, no foreign tax credit is available in Canada for U.S. withholding taxes paid. The second option available, reporting rents on a net basis, provides a better matching of income and credits in both countries.

2. Net Rental Election:

Nonresidents may elect to report U.S. rents on a net basis and pay U.S. tax on the net taxable income at the graduated tax rates. Often there is no U.S. tax payable because the deductions, which must include depreciation, produce a net loss for tax purposes. Losses can be carried forward and may be used to offset any gain from the real estate's sale in a future year.

The net rental election is made by filing an income tax return and reporting the rents on a net basis by June 15 following the calendar year end. Nonresidents who jointly own property must file separate U.S. tax returns. Consequently, where a nonresident owns U.S. real estate jointly with his or her spouse, separate returns must be filed for each spouse.

Nonresidents are also permitted a personal exemption claim ($2,750.00 in 1999) to offset net rental income. Additional personal exemption claims are available for their spouse and dependents if they have **no** U.S. source income and are not otherwise required to file a U.S. tax return.

B. Disposal of U.S. Real Estate:

When a nonresident disposes of U.S. real estate, an income tax return must be filed by

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June 15 following the year of disposition. The capital gain, if any, is subject to tax at the higher of the marginal individual income tax rate or the 20% Alternative Minimum Tax rate. Net rental losses from prior years returns can be used to offset the capital gain on disposition.

Purchasers of U.S. real estate must inquire about the residency status of the vendor at the time of sale. If the vendor is a nonresident, the purchaser must withhold 10% of the gross sale proceeds and remit this amount to the IRS. As the withheld amounts are often greater than the actual tax liability, the investor is forced to file an income tax return if he/she wants a refund. If prior years returns have not been filed, net rental losses from these years can not be used to offset the current years income.

It should be noted that the 10% withholding can be reduced by obtaining a withholding certificate from the IRS and presenting the same to the purchaser at the time of sale. The IRS requires detailed calculations showing that the actual tax liability on the disposition is less than the withholding.

Failure to File U.S. Returns:

As noted above, most Canadian residents generally report U.S. rents on a net basis. However, the net rental election is available only if a tax return is filed within a reasonable period of time. The IRS regulations provide that deductions will be denied where a return is not filed within 16 months of the original due date of the return (i.e. June 15 for the prior taxation year). Consequently, the 30% withholding tax on gross rents is mandatory and deductions and related loss carryovers can be denied.

C. Miscellaneous Topics:

Personal Use of Property:

If personal use of the real estate is combined with rental activity, certain expenses may be restricted or disallowed on the U.S. return.

Net Election and Raw Land:

Income must be derived from the U.S. real estate to qualify for the net rental election. For example, the net election is not available where the nonresident owns raw land located in the U.S. that produces no gross income during the taxable year. The problem with being unable to use the net rental election is that the taxpayer cannot claim deductions for real estate taxes, mortgage interest and other expenses incurred with respect to the property. Since these expenses cannot be capitalized they are lost forever. To overcome this problem, it is common practice for nonresidents holding unimproved real property to generate some income from the property such as parking or grazing fees or from the sale of timber or minerals. Once the net rental election has been made, it is in effect for subsequent years even though the property does not generate any more income.

State Tax Considerations:

Many investors address the annual Federal filing requirements but ignore the State requirements. When a property is sold, and the vendor(s) are foreign persons, many States require taxes to be withheld by the purchaser. Rental losses from prior years will not be available to offset the capital gain if past State tax returns have not been filed.

Future U.S.TAXFAXs will cover related issues on this topic such as alternative methods of purchasing U.S. real estate, the alternative minimum tax and estate tax issues.