# The U.S.TAXFAX

**TOPIC: U.S. TAX CONSEQUENCES ON THE SALE OF U.S. REAL PROPERTY**

**Date of Issue: May of 1997**

This edition of the U.S.TAXFAX will discuss the tax consequences of U.S. property dispositions by non resident individuals of the United States.

**Filing Requirements:**

The disposition of a U.S. real property interest (USRPI) by a U.S. non resident is taxable in the U.S. as effectively connected income. Non-Residents must report the capital gain or loss on Form 1040NR and pay tax at the individual marginal income tax rates. Form 1040NR is due on or before June 15 following the calendar year of disposition. Alternative Minimum Tax (AMT) often applies on the disposition of a USRPI and ensures that a minimum tax rate of 26% will be applied to the net capital gain.

If the taxpayer has rental losses from the current year, or losses which are being carried forward from prior years, they can be used to offset the capital gain (see the first edition of the U.S.TAXFAX for a discussion on the treatment of U.S. rental properties).

**U.S. Real Property Interest (USRPI)**

A USRPI is defined as:

1. A direct interest in real property such as U.S. real estate and improvements, including the building and any other inherently permanent structure.

2. An interest in a partnership (whether the partnership is U.S. or Canadian) if 50% or more of the value of the gross partnership assets consists of USRPIs.

3. An interest in a U.S. Real Property Holding Corporation. This is basically an interest in a U.S. domestic corporation in which the fair market value of the corporation's USRPI (e.g. real estate) equals or exceeds 50% of its total real property interests plus other assets used in a trade or business.

**Withholding of Tax on Disposition:**

**Federal Tax:**

If the vendor of a USRPI is a non resident individual, the purchaser must withhold 10% of the gross purchase price and pay this amount over to the IRS. This withholding tax represents a prepayment of the vendor's tax obligation and can be claimed as a credit on the vendor's U.S. tax return.

There are, however, some exceptions to the 10% withholding requirement. It should be noted that the exceptions reduce or eliminate the obligation of the purchaser to withhold but do not affect the filing requirements of the vendor. This means that the vendor must file a U.S. tax return whether tax is withheld or not.

The most common exception to the 10% withholding requirement is where the vendor obtains a withholding certificate from the IRS which provides that no withholding, or a reduced withholding, is permitted. Withholding certificates will be issued in a variety of circumstances with the most common being when the vendor's maximum tax liability from the

#42 - 1480 Foster Street,
White Rock, B.C. (V4B 3X7)
Bus: (604)531-6207
Fax: (604)538-9713
Web: www.kvdb.com
Marc W. Kotler, CA
Wes van den Brink, BBA, CGA

disposition is less than 10% of the gross sales proceeds. This will be the case if there is little or no gain arising from the disposition or if the vendor has sufficient net operating losses available from prior periods to reduce or eliminate the gain.

A withholding certificate is obtained by submitting an application to the IRS. There are very particular requirements regarding the structure and content of the application and deviations will result in significant processing delays. As the IRS has 90 days to respond to the request for a withholding certificate, it is generally recommended that the application be submitted on or before the closing date for the sale.

Another exception to the withholding requirement is if an individual acquires the property for use as a **residence** and the purchase price is $300,000 or less. The property qualifies as a residence if the purchaser, or immediate family, resides at the property for the requisite number of days over a two year period. The purchaser will be liable for the underwithheld taxes if this exception is relied upon, and he or she does not reside at the property the required number of days. This is the case only if the vendor does not file an income tax return and report the full amount of gain.

The residence exception is not always advisable from the purchaser's perspective as most of the benefits of this exception accrue to the vendor and the risks accrue to the purchaser - purchaser is liable for underwithheld tax if property not used as a residence and the vendor does not file return and report transaction. In most cases, the purchaser would rather withhold the 10% unless some tangible benefit is obtained from the vendor, such as a reduced purchase price.

**State Tax:**

Many investors in USRPIs address the Federal filing requirements but ignore the State requirements. Most states require foreign taxpayers to file tax returns and report the capital gain or loss on the disposition of real property located in the state. To ensure compliance with these rules, the purchaser is often required to withhold a percentage of the gross sales price as a prepayment of the vendor's State income tax obligation. Similar to the federal provisions, this withholding can often be reduced by filing the necessary forms with the State on or before the closing date.

**Current Development:**

Canada and the U.S. have agreed to recommend changes to the Canada-United States tax treaty. The most important change relates to the taxation of social security benefits (e.g. CPP payments and U.S. social security). At present, social security benefits are taxed only in the country of source. This results in U.S. withholding taxes of 25.5% on gross U.S. social security benefits paid to Canadian residents, regardless of their worldwide income. This often has a detrimental effect on low income seniors.

The proposed new rule will give the country of residence the exclusive right to tax social security benefits. The Canadian taxation of U.S. social security benefits will be subject to special rules that take into account how the benefits would have been taxed to a U.S. resident.

The Department of Finance has stated that the new rules will apply retroactively to January 1, 1996 and any taxpayer whose overall tax liability is reduced using the new rules may apply for a refund. Apparently, Canada will also ensure that the 1996 tax liability using the new rules will not exceed the tax already withheld by the U.S.. We will keep you posted on any developments in this area.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained.