BY JAMIE GOLOMBEK

Due South

How the White House plans to ease the tax burden for Canadians with U.S. vacation properties

Canadians snowbirds who own U.S. vacation property need to be aware of how U.S. taxes could affect them. Fortunately, for some, the White House's proposed tax plans could substantially ease the tax burden and planning south of the border.

U.S. persons are taxed on their worldwide income and may also face U.S. gift and estate taxes. Individuals are considered to be U.S. persons if they are U.S. citizens, green card holders, meet the substantial presence test for income tax purposes (which looks at the number of days spent in the U.S. over the last three calendar years), or are domiciled in the U.S. (for estate and gift tax purposes.)

Many Canadians, however, are not considered to be U.S. persons and are only subject to U.S. taxes on a limited basis, one of which is through the ownership of U.S. real estate. Let's take a look at some U.S. tax considerations for Canadians who own a U.S. vacation home and who are not U.S. persons for tax purposes.

When a Canadian owns a U.S. vacation property and rents it to others, the tenant is required to withhold 30 per cent tax. The owner may, however, elect to have the income treated as income from a U.S. business so that the U.S. withholding tax would not apply. If the owner makes this election, the U.S. rental income must be reported on an annual U.S. income tax return, but applicable expenses may be deducted. The net rental income will be taxed at graduated U.S. federal tax rates.

If the Canadian owner sells the U.S. vacation property, there may be U.S. income tax on any capital gain. Currently, the maximum federal tax rate is 20 per cent for "long-term" capital gains, provided the property has been owned for more than one year prior to sale. If the property has been owned for one year or less, graduated U.S. federal income tax rates apply to what's known as a "short-term" capital gain.

Under current legislation, graduated income tax rates in 2017 range from 10 per cent to 39.6 per cent (with taxable income exceeding US$418,400 for a single individual). The White House's tax plan calls for a reduction in the number of U.S. federal income rate brackets from the current seven brackets to only three: 12 per cent, 25 per cent, and a top rate of 33 per cent (for income above US$112,500). These rates would apply to rental income and short-term capital gains, but there would be no change to taxation of long-term capital gains, for which a maximum rate of 20 per cent would continue to apply.

In addition, under "Obamacare," a 3.8 per cent "net investment income tax" (NIIT) applies on net investment income, including interest, dividends, and capital gains. President Trump campaigned on a promise to repeal Obamacare, which could also eliminate the NIIT.

The other area in which he promised reform is the U.S. transfer tax system, which includes gift tax, generation-skipping transfer tax, and estate tax.

Rather than selling, suppose the Canadian owner wants to gift a U.S. vacation home, perhaps to keep it in the family for future generations. Gifts of U.S. real estate are subject to U.S. federal gift tax at rates ranging from 18 per cent to 40 per cent of the fair market value of the property. There is a limited gift tax exemption for Canadians on gifts up to US$14,000 per recipient annually, which isn't very helpful for most vacation properties. And if property is gifted to an individual who is more than one generation younger, such as a grandchild, a 40 per cent U.S. federal generation-skipping transfer (GST) tax may be added to the tax bill. Since the gift tax and GST tax can be significant, gifting a U.S. vacation property is generally not advisable.

The U.S. also has a federal estate tax that applies to the fair market value of U.S. real property upon death. The U.S. estate tax was enacted in 1916 and was already repealed once: for the year 2010, but came back again as of Jan. 1, 2011. For 2017, there is a U.S. estate tax exemption of US$5.49 million. Canadians may claim a prorated exemption, based on the proportion of their U.S. property to their worldwide estate, such that an individual with a worldwide estate valued at under US$5.49 million will generally have no estate tax liability on their U.S. vacation property. Consequently, few estates would actually owe any estate tax; however, for those that do, the amount can be significant, as the top federal estate tax rate is 40 per cent. (State estate tax may also apply in some states.)

In his campaign platform, the President said that he would "repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms." It is unclear whether this plan would involve only the repeal of the estate tax or whether the generation-skipping transfer and estate or gift taxes would also be affected. It is possible that estate tax could be eliminated, while the other taxes remain in place, as was the case in 2010 when only the estate tax was repealed. If all transfer taxes were eliminated, then much of the complex planning currently being done, often involving setting up trusts and corporations to plan around the gift, GST, and estate taxes, may need to be revisited.

For clients who own U.S. vacation properties, 2017 could prove to be an important year for them to closely follow U.S. tax developments. F

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