BDO

TAX BULLETIN

U.S. TAX ISSUES FOR CANADIANS

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CONTENTS

- Snowbirds and commuters
- Students, teachers and trainees
- Canadians owning U.S. real estate
- Summary

If you own rental property in the United States or spend extended periods of time there, you could be subject to various U.S. filing requirements, even though you may have no U.S. tax to pay.

The U.S. government refers to individuals who are not U.S. citizens or who do not live the in U.S. as “nonresident aliens”. The U.S. government is concerned about nonresident aliens avoiding taxes or taking aggressive filing positions, and about the difficulty of monitoring these developments. In response, U.S. legislators have introduced a number of measures over the years to stop what they perceive as abuse of the system, by tightening deadlines and increasing penalties for failure to comply. With Canadians being significant investors in the U.S., it’s not surprising that they should bear much of the administrative burden of these requirements.

This bulletin outlines the rules and the penalties that could apply for not complying with these filing requirements. The comments below are aimed at Canadian residents — that is, individuals who are considered resident in Canada for tax purposes and pay taxes here. We’ll simply refer to them as “Canadians”. If you’re a Canadian citizen living full-time in the U.S., there may be other considerations not covered in this bulletin.

If you are a resident of another country (other than the U.S.), it’s likely that many of the comments in this bulletin also apply to you since they arise from U.S. domestic tax law. Finally, if you’re a U.S. citizen or U.S. “Green Card” holder living in Canada, ask your BDO advisor for a copy of our tax bulletin titled *Tax Consequences for U.S. Citizens and Other U.S. Persons Living in Canada* for information on your U.S. tax and filing requirements, as the comments in this bulletin do not apply to you.

All references to dollar values in this bulletin are denominated in U.S. dollars.

Snowbirds and commuters

As the nickname implies, “snowbirds” are Canadians who spend a considerable amount of time in the U.S. (often to escape our winters).

If you are a snowbird, there are a number of U.S. tax issues that you should be aware of because the last thing you want is to find yourself inadvertently liable for U.S. income tax or subject to U.S. penalties for failing to satisfy U.S. filing requirements.

Does the U.S. consider you a U.S. resident?

Despite the fact that you might consider yourself to be resident in Canada (for example, because you pay Canadian income taxes), if the number of days you spend in the U.S. exceeds certain thresholds, you may be considered a U.S. resident. The U.S. Internal Revenue Service (IRS) applies a test known as the "substantial presence test" to determine whether an individual who spends part of the year in the U.S. is a resident of the U.S. for U.S. income tax purposes.

Substantial presence test

Under the substantial presence test, you will be considered a U.S. resident under U.S. domestic tax law if:

- the weighted total of the number of days you spent in the U.S. over the last three years (determined using the formula set out below) equals or exceeds 183 days, and
- you have been in the U.S. for more than 30 days in the current year.

The weighting formula that is used in the substantial presence test is as follows:

The number of days in the U.S. this year,
Plus
1/3 of the number of days in the U.S. last year,
Plus
1/6 of the number of days in the U.S. the year before last

Obviously, if you spend 183 days (roughly 6 months) in the U.S. in any given year, you will meet the substantial presence test. However, if you regularly spend as much as 4 months a year in the U.S. (122 days), you will also be considered a U.S. resident under this formula.

Given that the substantial presence test relates to the number of days you are in the U.S., it is important that you count your U.S. days carefully. Even if you are present in the U.S. for just a portion of a day, it is counted as a full day for the purposes of this test. However, some of the days you are in the U.S. may be excluded from the calculation. Days that are excluded include:

1. Days that you commute to work in the United States from Canada;
2. Days you were in the U.S. where you can show that you intended to leave earlier, but were unable to because of a medical condition that developed while in the U.S.;
3. Days when you were in transit in the U.S. for less than 24 hours on your way to another foreign country (for example, if you had a layover in Chicago on your way to Mexico);
4. Days in the U.S. while on a special student or teacher visa.

To exclude days of presence in the U.S. for purposes of the substantial presence test calculation, you may need to file Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*, to explain the basis of your claim. Filing deadlines are discussed later in this bulletin.

COVID-19 relief for the substantial presence test

Previous Internal Revenue Service ("IRS") guidance under Revenue Procedure 2020-20 provided specific guidance with respect to the substantial presence test in light of COVID-19 for calendar 2020. Such guidance does not apply to years after 2020.

Consequences of being considered a U.S. resident

If you meet the substantial presence test in any given year, you're automatically considered a U.S. resident for U.S. tax purposes for that year. Absent taking any measures to disclaim U.S. residency, you would be subject to U.S. tax and filing requirements based on your worldwide income. This will be so, even though you may also be a Canadian resident and pay Canadian taxes.

If you are considered a U.S. resident, you can do one of two things to disclaim U.S. residency:

1) you can claim the "closer connection exception" allowed under the Internal Revenue Code (the Code), or
2) you can claim treaty benefits under the Canada - U.S. Income Tax Convention (the Treaty).

Claiming the “closer connection exception”

You can avoid being considered a U.S. resident by claiming that you actually have closer connections with another country (such as Canada). To claim the closer connection exception, you must file Form 8840, *Closer Connection Exception Statement for Aliens*, with the IRS. On Form 8840, you must indicate the number of days you spent in the U.S. and you must answer questions that demonstrate that you had a closer connection with Canada during the year.

Factors that indicate a closer connection with Canada include:

- having a permanent home in Canada,
- having family in Canada,
- having personal belongings in Canada,
- being entitled to health care services paid by a provincial health insurance plan,
- banking in Canada,
- carrying on business in Canada,
- having a Canadian driver’s licence, and
- voting in Canada.

Questions about your involvement in social, cultural, religious, political and professional organizations are not on the form. However, these factors are still relevant in establishing a closer connection to Canada.

You cannot claim the closer connection exception if:

- you spend 183 days or more in the U.S. in the current year,
- you have, or have applied for, a U.S. “Green Card” to establish permanent resident status in the U.S., or
- you did not file Form 8840 by the due date, and cannot establish reasonable cause for late filing to the satisfaction of the IRS.

When filing Form 8840 to claim the closer connection exception, you do not need a U.S. taxpayer identification number. However, you must sign Form 8840 under penalty of perjury, which means you could be subject to prosecution for reporting false information.

The deadline for filing Form 8840 and the penalties for failure to file are discussed below.

Dual resident individuals (non-U.S. citizens)

If you cannot claim the closer connection exception, then you are a dual resident and therefore considered to be a resident of both Canada and the U.S. under each country's tax laws. In such cases, the Treaty has “tie-breaker” tests under which your residence for purposes of income taxation is ultimately determined.

Canadian resident under tie-breaker tests

For those who are resident of both Canada and the U.S. under their respective domestic tax laws, the Treaty lays out tie-breaker tests that must be applied in sequence until one of the tests becomes determinative in favour of Canadian or U.S. residency. The tests are:

- location of “permanent home”
- location of “center of vital interests” (based on familial, social and economic ties)
- location of “habitual abode”
- citizenship
- mutual agreement of Canadian and U.S. tax authorities

The application of the tie-breaker tests is based on one's facts and circumstances, and often requires professional judgment.

If you tie-break to Canada, the Treaty will generally protect you from having to pay U.S. tax on income from sources outside the U.S. However, you are still subject to the filing requirements of the Code and the penalties for not adhering to them.

If you are considered resident in the U.S., but you cannot claim the closer connection exception (for example, if you spent 183 days or more in the U.S. in the year), you must file Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*, for the year in question and also claim treaty benefits as explained below. In addition, you may also still be subject to certain U.S. foreign reporting requirements normally applicable to U.S. residents.

On the Form 1040-NR, you must declare all U.S. source income. For snowbirds, this is usually only interest and dividends, both of which are normally subject to a flat non-resident withholding tax (with interest currently subject to a 0% withholding rate and dividends subject to a 15% withholding tax rate). Any income and taxes withheld are reported on Form 1040-NR and this return must be signed under penalty of perjury.

Claiming Treaty benefits

To claim Treaty benefits, you must attach a completed Form 8833, *Treaty-Based Return Position Disclosure under Section 6114 or 7701(b)*, to your Form 1040-NR. On Form 8833, you must explain that you are a resident of Canada and are not subject to regular U.S. income tax rates on this U.S. source income under the provisions of the Treaty.

Both the Form 1040-NR and Form 8833 require a U.S. taxpayer identification number. For individuals who are not eligible to obtain a Social Security Number (SSN) (generally individuals without permission to work in the U.S.), this number is known as an "Individual Taxpayer Identification Number" (ITIN). To obtain an ITIN, you must file Form W-7, *Application for IRS Individual Taxpayer Identification Number*, with proof of identity and foreign status, along with your original completed tax return. After the W-7 has been processed, the IRS will assign an ITIN to you and process the return. If you do not have a return filing requirement, but meet one of the exceptions for obtaining an ITIN (for example, individuals subject to third party withholding on passive income or on proceeds from sale of U.S. real estate), you will be required to file specific documentation with the W-7 instead of a tax return.

Normal filing deadlines

Individuals are taxed based on the calendar year in the U.S., just as they are in Canada. Form 1040-NR with Form 8833 (to claim treaty exemption) must be filed by June 15 of the following year. However, if you have employment income subject to U.S. withholding tax, the filing deadline for Form 1040-NR is April 15 of the following year.
Form 8840 (to claim the closer connection exception) and Form 8843 (to exclude U.S. days for purposes of the substantial presence test) are filed together with Form 1040-NR, if the Form 1040-NR is required to be filed. Otherwise, Forms 8840 and 8843 should be filed separately by June 15.

Penalties

If you fail to file Form 8840 by the due date and the IRS subsequently determines that you met the substantial presence test, the IRS could require you to file a U.S. tax return. Although you can claim Treaty protection from U.S. tax at the time you file the return, you would still be subject to the non-disclosure penalties under the Code. These penalties could be as much as $1,000 for each item of income involved. Note that the Treaty does not protect you from these penalties.

In addition, as mentioned above you could be subject to U.S. foreign reporting requirements if you fail to file Form 8840 on time. The penalties associated with non-compliance in connection with these requirements could be very high, depending on the applicable form. Several of these forms carry penalties of $10,000 or more for late filing or failure to file.

These penalties are the main reason we encourage clients to file when required. There is usually no U.S. tax cost to filing and you can protect yourself from incurring substantial penalties at some point in the future.

U.S. resident under tie-breaker rules

If, after applying the tie-breaker rules, you are considered a U.S. resident, you would pay tax on your worldwide income in the U.S. and only be subject to Canadian tax on your Canadian source income. If you were previously a Canadian resident, that's not the end of the story.

In such a case, you may be treated as a non-resident for Canadian income tax purposes. This means that, whether you intentionally emigrated or not, you will be deemed to have disposed of most of your non-registered assets for Canadian tax purposes, and will have to pay tax on any capital gains that have accrued. Most commonly, the deemed disposition rules apply to marketable securities and foreign real estate holdings. Registered accounts are not subject to this deemed disposition. Registered accounts include pensions, RRSPs, RRIFS, RESPs and TFSAs. The disposition will occur on the day that you are considered to have left Canada.

These rules could affect individuals who leave Canada for a short-term stay in another country, and where, for example, they do not retain a home in Canada. Proper planning can reduce the impact of these rules. Your BDO advisor can assist you in determining how these complex rules apply to you.

Commuters

Commuters are individuals who are not U.S. citizens and who regularly commute to work in the United States from their residence in Canada. The term “commute” means that you travel to work in the U.S. and return to your residence in Canada within a 24-hour period. You are considered to regularly commute from Canada if more than 75% of your workdays are in the U.S. As noted above, if you meet these criteria then the days you are working in the U.S. are not considered as days present in the U.S.

If you are working for a U.S. employer, you will receive a Form W-2 statement of wages. Since you have wages subject to withholding, you must file a tax return Form 1040-NR by April 15 of the following year. You may request an extension of time to file your tax return to October 15 by filing Form 4868 on or before the original due date of April 15. Any balance owing should be paid by April 15 to avoid any potential penalties and interest.

If your wages are subject to state and local tax withholdings, you will need to file tax returns in those jurisdictions as well.

When you file your Canadian income tax return, you may claim a foreign tax credit for taxes paid to the U.S. to reduce your Canadian taxes payable.

If you are working for a Canadian employer but regularly report to work in the U.S., you may have U.S. filing obligations.

COVID-19 guidance for commuters

Previous guidance issued in 2021 by the Canada Revenue Agency (CRA) clarified its positions with respect to COVID-19 and commuters who are on the U.S. payroll of their employer and were working from home in Canada as a result of travel restrictions.

Under the Treaty, an individual should source their employment income between Canada and the U.S. based on the number of days worked in each country. Sourcing determines which country has the first right to tax the income. This would mean that for those days worked from home, the commuter would ultimately be paying tax in Canada as opposed to the U.S. For example, if a Canadian earned $100,000 from a U.S. employer, and worked 75% from home in Canada in 2020, $25,000 of their wages would be sourced to the U.S., and $75,000 would be sourced to Canada. Filing tax returns accordingly would create a large balance of tax payable in Canada (where no tax has been withheld on the $75,000), and a large refund in the U.S. (where tax has been over-withheld on the full $100,000).

As stated above, the CRA clarified the options for 2020 and 2021 for commuters working from home in Canada. A commuter could choose to source their wages based on days worked pursuant to the Treaty and file their Canadian and U.S. tax returns based on where they physically worked. Alternatively, an individual could file their Canadian and U.S. returns as they have in prior years without having to source their wages based on days worked in each country. If an individual chose to file based on sourcing income based on

days worked in each country, additional guidance was provided by the CRA.

At this point, the CRA has not indicated that they will extend this relief to the 2022 tax year and beyond and a commuter should carefully consider the cross-border tax implications of working from home in Canada for a U.S. employer.

Students, teachers and trainees

As mentioned in the substantial presence test section of this bulletin, individuals present in the U.S. while on a special student or teacher visa may be able to exclude days of presence in the U.S. for purposes of the substantial presence test.

A student is an individual who is temporarily present in the U.S. on an F, J, M or Q visa for the purpose of education. A teacher or a trainee is an individual who is not a student and who is temporarily present in the U.S. under a J or Q visa.

In order to be able to exclude days of presence in the U.S. for purposes of the substantial presence test; students, teachers and trainees must substantially comply with the requirements of their visa. They also have to file Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*.

In addition, if you are a student and you exempted your days of presence in the U.S. for the purposes of the substantial presence test for any part of more than five calendar years, you must also establish that you don't intend to reside permanently in the U.S.

If you are a teacher or trainee and you exempted your days in the U.S. for the purposes of the substantial presence test for any part of two of the six prior calendar years, you must also establish that all of the following requirements apply to you:

- You were exempt as a teacher, trainee, or student for any part of three (or fewer) of the six prior calendar years;
- A foreign employer paid all your compensation during the year;
- You were present in the United States as a teacher or trainee in any of the six prior years; and
- A foreign employer paid all of your compensation during each of those prior six years you were present in the United States as a teacher or trainee.

If you are a student, a teacher or a trainee who otherwise meets the requirements to exempt your days of presence in the U.S. for the purposes of the substantial presence test, but you fail to file Form 8843 and you spent 183 days or more in the U.S. in the year, you will be considered a U.S. resident for U.S. income tax purposes. This means that you could be taxed on your worldwide income in the U.S. and you would be subject to U.S. foreign reporting requirements. As mentioned above, the penalties associated with non-compliance in connection with U.S. foreign reporting requirements could be very high, depending on the applicable form. Several of these forms carry penalties of $10,000 or more for late filing or failure to file.

The deadline for filing Form 8843 is discussed above.

Please note that, if you are in the U.S. on a student visa, this does not automatically qualify you to work in the U.S. If you would like to work in the U.S. while on a student visa, in addition to the visa you are required to have a work permit (Employment Authorization Document - EAD) or a letter from the university confirming on-campus employment.

Students, teachers and trainees may be taxable in the U.S. on U.S. source income received even though they will likely be nonresident aliens as explained above. For example, the Canadian and U.S. tax systems treat scholarships and similar awards for post-secondary degrees differently.

For U.S. tax purposes, a nonresident of the U.S. could be taxable on all of or a portion of scholarships paid from U.S. sources. The Canadian tax system exempts most scholarships awarded to full-time students pursuing a post-secondary degree. The U.S. system will exempt the portion of a qualified scholarship received in respect of qualified education expenses. Such expenses are generally limited to tuition and course-related expenses, such as fees, books, supplies, and equipment that is required for the courses at the

eligible educational institution. Qualified educational expenses do not include expenses for room and board.

Furthermore, please note that a change to your immigration status in the U.S. could dramatically change your tax residency status and associated Canadian and U.S. tax filing requirements.

Canadians owning U.S. real estate

In addition to spending time in the U.S. on a regular basis, many Canadians own U.S. real property. Some people use it exclusively for personal enjoyment and some rent it out on either a full-time or part-time basis.

Renting U.S. real property

Absent any proactive measures, the rents received are subject to a 30% withholding tax which tenants (or property managers) are required to deduct from the gross rent paid and remit to the IRS. This applies even if the tenants or property managers are Canadians or other non-residents of the U.S. The Treaty allows the U.S. to tax income from real property according to U.S. domestic law, with no reduction in the general withholding tax rate. Tax at 30% is a high rate to pay on gross income.

If you have expenses associated with your U.S. real property (such as interest, property taxes and utilities), you would likely pay a much lower amount of tax if you were taxed on the basis of your net income from the property using U.S. tax brackets applicable to individuals. Fortunately, the Code allows nonresidents to elect to be taxed as though their income is effectively connected with a U.S. trade or business, which means you can deduct expenses incurred to earn such income.

Once this election is made, there is no requirement for your tenant or property manager to withhold tax, but if requested, you will need to complete Form W- 8ECI, *Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*, and provide it to your tenant or property manager so that they can pay you your rent in full without withholding any tax.

If you wish to deduct expenses in order to be taxed on a net income basis, you must file a U.S. tax return and meet certain other requirements. On your U.S. tax return (Form 1040-NR), you would show the income and expenses, as well as the amount of any tax withheld. You will be able to a get a refund of any excess tax withheld, as long as you file within 3 years from the date the return was due (including extensions).

Some people assume that because the election is always available and their expenses exceed their rental income, there is no need to worry about filing any U.S. tax forms or having tax withheld at source. This is not the case! If you want to take advantage of the net income election provided under the Code, you must satisfy the strict rules related to the timing and content of the required filings. If you do not meet the deadlines and requirements for filing, you could lose the right to make a net income election and, therefore, could be exposed to tax at 30% on your gross rental income.

Filing requirements when making a net income election

To make the net income election, you must file a Form 1040-NR, including a statement declaring that you are making the election. The election should include the statement that you are making the election, the relevant section of the Code, the address of the property, your percentage ownership, a description of any substantial improvements made to the property and details of any previous election or revocation of the net income election. Once made, the election is valid for all subsequent years and does not have to be repeated unless you acquire a new property. Keep in mind that even though the election does not have to be made every year, you must still file a Form 1040-NR each year to report the income, expenses and any tax withheld.

In Canada, your net rental income will be taxable and a foreign tax credit for U.S. taxes paid on the net rent may be claimed to reduce your Canadian taxes payable.

It should also be noted that if you own U.S. rental property, you may also be required to comply with Canada's foreign reporting requirements (Form T1135).

Deadlines for making the net income election

As noted above, Form 1040-NR is normally due by June 15 of the year following the calendar year in question. You can file Form 1040-NR late if no taxes are payable, but the net income election will generally only be valid for a particular year if the return is filed no later than 16 months after the original due date of the return. (For corporations, the deadline is 18 months after the original due date.)

The following table summarizes the deadlines for returns of individuals making the net income election for the last three years:

Taxation Year	Deadline
2020	October 17, 2022
2021	October 16, 2023
2022	October 15, 2024

Penalties

Failure to file a return within the 16-month period will result in you being subject to tax on a gross income basis for that year. That is, you will be subject to tax on the gross rents at 30%, with no deduction for any expenses incurred. The intent is to force people to file the required returns on a timely basis.

Regulations provide that filing deadlines may be waived if the taxpayer establishes that based on the facts and circumstances, they acted reasonably and in good faith when they failed to file a U.S. income tax return. However, taxpayers are deemed not to have acted reasonably and in good faith, if they knew they were required to file a U.S. income tax return, but chose not to.

Some of the factors the IRS considers in determining whether a non-filer acted reasonably and in good faith include:

- Did the taxpayer voluntarily identify himself or herself to the IRS (in other words, did they file a return)?
- Was the taxpayer honestly unaware of the filing requirements?
- Did the taxpayer previously file U.S. returns?
- Were there intervening events that were beyond the taxpayer's control which prevented filing?
- Were there other mitigating circumstances?

Selling U.S. real property

Canadians selling U.S. real property (whether rented, or held exclusively for personal use) are liable for any U.S. taxes that result from the sale, and will be required to file a U.S. nonresident income tax return (Form 1040-NR) to report the disposition. There are two U.S. tax processes to keep in mind — withholding tax and filing the U.S. income tax return.

Withholding tax

The sale of a U.S. real property by a Canadian is subject to withholding tax under the *Foreign Investment in Real Property Tax Act* (FIRPTA). With certain exceptions, the purchaser will be obligated to withhold and remit tax of up to 15% of the gross proceeds to the IRS on behalf of the seller.

If your estimate of actual taxes, calculated as noted under the next section titled *Filing a U.S. income tax return*, will be less than this withholding tax, you can apply for a withholding certificate from the IRS. This will allow you to reduce the amount of withholding to an estimate of the maximum tax that could apply on the net gain (i.e. gross proceeds less the cost of the property), based on the top bracket tax rate applicable to the net gain (20%, for a property held for a year or longer).

In order to apply for the withholding certificate, you will need to file Form 8288-B with the IRS on or before the date that the sale of the property closes and notify the buyer that you have applied for a certificate.

The IRS requires documentation to be attached to Form 8288-B to substantiate the original purchase price, cost of capital improvements and the selling price. The IRS will normally act within 90 days of receiving the completed form and all required documentation, but the process can take longer in some cases. Note that Form 8288-B requires that an ITIN be provided. (Please see discussion of ITIN under “Claiming Treaty benefits” above). If you do not already have an ITIN, you will need to apply for it by completing Form W-7 and sending the completed Form W-7 in with Form 8288-B.

An exception to this withholding requirement may apply where the purchaser signs a statement indicating that the purchase is for use as a residence and that they have definite plans over the next two years to reside in the property for at least 50% of the time that it is used. Where this residence test is met and the property is sold for gross proceeds of $300,000 or less, there is no withholding. A 10% withholding tax rate applies where the purchaser will use the property as a residence and where the property is sold for gross proceeds of between $300,000 and $1,000,000.

The purchaser of the property will need to file Forms 8288 and 8288-A to report and remit the withholding tax; generally, within 20 days of the sale. If an application for a withholding certificate has been submitted but is still pending with the IRS on the date of closing, the purchaser will need to first withhold the 15% (or 10%) of gross proceeds and retain the funds in escrow, which can later be fully or partially released to the seller if a withholding certificate is granted. The IRS requires remittance of the reduced withholding amount within 20 days following the day the withholding certificate or notice of denial is mailed by the IRS. To minimize the length of time the funds remain in escrow, it is generally advisable to file Form 8288-B as soon as possible after a firm offer to sell the property is in place.

Filing a U.S. income tax return

You will need to file Form 1040-NR to report the sale of the property and to pay tax on any gains on the sale of the property. If you have used the property only for personal use, and have not rented it out, the amount of the gain is determined by taking gross proceeds (reduced by selling costs) and subtracting the cost of the property. The U.S. tax is then calculated on the net gain. The rate of tax applied will depend on the amount of other U.S. source income, if any, that you need to report in the year, and the amount of the gain. Note that the U.S. taxes the entire capital gain, not 50% of the gain as in Canada, but the rate on long-term capital gains (gains on assets held more than a year) is a fixed rate which is lower than the tax rate on ordinary income. Depending on income level, the gain is subject to tax at 0%, 15% or 20%. The amount of withholding tax applied at the time of sale will be taken as a credit on this tax return. Even if the property is sold at a loss and there was no withholding tax at source, Form 1040-NR is still required to be filed.

For property that was rented, and in respect of which the net income election was made, you should consult your BDO advisor regarding calculating the tax on the sale. This is because the cost of the property for U.S. tax purposes will reflect depreciation on the property that you were required to calculate for U.S. purposes, and also, you may have net operating losses carrying forward to the year of sale.

Am I subject to Canadian income tax on the sale of my U.S. property?

Yes, as a Canadian resident, you are subject to Canadian income tax on worldwide income, which includes any capital gains realized on U.S. real property. In Canada, only 50% of the capital gain is included in taxable income and you will generally be allowed to claim a foreign tax credit for the U.S. income tax paid. The result is that you will end up paying tax at the higher of the two countries’ tax rates, but should not be subject to double taxation. It is important to note that your Canadian tax is determined in Canadian currency and as such, all U.S. amounts need to be translated to Canadian dollars at the transaction dates. This

will result in a foreign exchange gain or loss being recognized on the sale of the property.

Can I claim the principal residence exemption to reduce Canadian tax?

You may be able to claim the principal residence exemption to reduce or eliminate the taxable capital gain in Canada. In order to qualify as your principal residence, generally, the property must be owned or jointly owned by you and another person and ordinarily inhabited by you or your family. Even though you only live in your U.S. vacation property for a short time in the year, it can still qualify. However, if the main purpose of owning the residence is to earn income, then it will not qualify.

Note that if you or your spouse or common-law partner own more than one residence during a year, you will need to decide which one you want to designate as your principal residence for that year, which will then allow you to claim the exemption in respect of that year.

If you choose to claim the principal residence exemption on your U.S. property for one or more years, any remaining taxable capital gain, after the principal residence exemption, will be taxed at your personal marginal tax rates. While it is possible to use this exemption to reduce your taxable capital gain to nil, you will still be liable for U.S. tax. As such, it would generally make sense to pay at least as much Canadian tax as is necessary to fully use the U.S. taxes paid as a non-refundable foreign tax credit against your Canadian tax. Due to the U.S. tax, you may want to preserve some or all of the principal residence exemption for another home that you also owned during the same time.

Some other considerations in designating a principal residence include the cost, value, levels of accrued gains and years of ownership of all your residential properties.

Ownership options for U.S. real property

Aside from owning U.S. real property personally, other common options include ownership via:

- Canadian corporation
- Canadian trust
- Canadian partnership

Even if the property is simply being held personally, there are different options in situations where there are multiple owners. Two common options are joint tenancy with rights of survivorship, and ownership as tenants in common.

There is no universally best method for a Canadian to hold U.S. real estate. Each method has various advantages and disadvantages, and it is a matter of which factors are most important to you. Both tax and non-tax factors should be taken into consideration.

Planning should be undertaken well in advance of the purchase to decide on the appropriate ownership method, since making an uninformed choice could result in adverse unexpected consequences. Furthermore, changing the ownership method after the property has been purchased can be costly. If you require guidance, please contact your BDO advisor.

U.S. estate tax

Canadians who die owning U.S. real property could be subject to U.S. estate tax based on the value of their U.S. situs assets, which include assets such as U.S. real estate or U.S. marketable securities.

Exposure to estate tax depends on factors such as the value of one's U.S. situs assets and the value of their worldwide estate. Under current legislation, U.S. estate tax is a maximum of 40%.

For further information on U.S. estate taxes, contact your BDO advisor, and also see the BDO Tax Bulletin, *U.S. Estate Tax Issues for Canadians*.

Summary

As you can see, a Canadian snowbird will often have to file a U.S. Form 8840, *Closer Connection Exception Statement for Aliens* each year. As also discussed above, a different filing may be required based on individual circumstances. Such filings could include a U.S. Nonresident Alien Income Tax Return, with a treaty-based return disclosure, or a regular non-resident U.S. income tax return to report rental income, disposition of U.S. real property, or U.S. sourced employment income. A full U.S. tax return may even be required in certain circumstances. Your BDO advisor can help you to navigate the U.S. income tax filing landscape (and related Canadian income tax filings) to help minimize your taxes and penalties.

In this bulletin, the U.S. taxes we have been referring to are U.S. federal income taxes. However, state income taxes, which vary from state to state may also apply.

We strongly encourage all clients to comply with IRS filing requirements. In most cases, this involves simply filing a return or statement, with no actual tax owing. It's to your advantage to maintain yourself in good standing for future dealings with the U.S. authorities, particularly if you maintain a residence or have other assets there.

Don't let the situations discussed above happen to you — ensure that all your required U.S. filings are made on a timely basis. Your BDO advisor is ready to help.

If you have questions regarding how the U.S. personal income tax rules might affect you, please contact our U.S. Tax Practice Leaders in Canada:

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The information in this publication is current as of March 1, 2023.

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