Wealth Management

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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Ownership of a Canadian home or vacation property by U.S. persons living in Canada

Understanding your U.S. tax exposure and potential strategies to minimize it

Please note this article assumes you're a U.S. person for U.S. income tax purposes (i.e. a U.S. citizen or U.S. resident, including a U.S. green card holder) living in Canada. If you're not sure whether you're considered a U.S. person, please ask an RBC advisor for a separate article that discusses that topic.

Within the Canadian income tax system, there are special tax benefits to Canadian residents who own a home or vacation property. If your home or vacation property qualifies as your principal residence, the capital gain triggered when disposing of it (e.g. selling it or gifting it) may be fully or partially exempt from Canadian income tax. While U.S. income tax laws provide similar benefits to U.S. persons, there are differences in the criteria that should be met for the property to qualify, as well as limits on the amount of the gain that may be tax-exempt. In addition, for U.S. tax purposes; if you have a mortgage on a property in Canada, you may be able to deduct the mortgage interest, subject to certain thresholds. This deduction is not available for Canadian tax purposes. Given the differences in taxation, an overall understanding of the Canadian and U.S. tax treatment, as well as planning opportunities, may be valuable in preventing tax surprises.

If you're a U.S. person living in Canada who owns a home or vacation property in Canada, this article discusses the U.S.

income tax issues that may apply and potential opportunities to minimize your overall income tax exposure that should be discussed with a qualified cross-border tax advisor.

Canadian tax rules regarding the principal residence exemption

For Canadian income tax purposes, a Canadian resident who sells or gifts their home or vacation property that has appreciated in value since the date of ownership will trigger a capital gain, unless the sale or gift is to a spouse. A capital gain isn't triggered if the home or vacation property is transferred to a spouse due to a separation or divorce settlement. Accrued capital gains are also triggered upon death, as you'll be deemed to have disposed of your home or vacation property — the exception here would be if the property is bequeathed to a surviving spouse. In all of these cases you can elect to transfer property to a spouse at fair market value (FMV). Keep in mind that there isn't a gift, estate tax, or inheritance tax system in Canada.

Generally, determining the gain or loss on the disposition of a property is calculated as the property's FMV (i.e. selling price) less disposition costs (i.e. selling costs) less the property's adjusted cost basis. (A discussion of the calculation of the adjusted cost basis for Canadian tax purposes is beyond the scope of this article.)

When a loss is triggered on the disposition of personal use property, such as a home or cottage, the loss generally isn't deductible. When a capital gain is triggered, the taxable capital gain is subject to tax based on your Canadian marginal tax rate (that rate varies, based on the province or territory you live in). However, the capital gain may be entirely exempt from Canadian income tax if you're able to claim the principal residence exemption for the entire period of ownership. A partial exemption of the capital gain may still be possible if the property doesn't qualify as your principal residence for the entire period of ownership.

Under the Canadian tax rules, you must have "ownership" of the property and it must be "ordinarily inhabited" in order for the property to qualify as your principal residence. This means you have to own the property either solely or jointly with one or more individuals and you, your spouse or your child must live in the property, even for a short period of time. For example, if you own a vacation property, such as a cottage, it may be considered ordinarily inhabited if you stay in the property during a short vacation. Keep in mind that property you purchase mainly for the purpose of earning income generally isn't considered to be ordinarily inhabited by you, even if you stay in the property for a period of time over the year. However, it's possible for you to earn incidental income (e.g. rental income) from a property and still claim it as your principal residence.

For Canadian income tax purposes, a Canadian resident who sells or gifts their home or vacation property that has appreciated in value since the date of ownership will trigger a capital gain, unless the sale or gift is to a spouse. A capital gain isn't triggered if the home or vacation property is transferred to a spouse due to a separation or divorce settlement.

If you're nearing or already in retirement, it's also worthwhile to note that if you move into a retirement residence or nursing home, your home will no longer qualify as your principal residence unless your spouse or a child continues to live in the home. In addition, a home located outside of Canada owned by a Canadian resident may qualify as a principal residence if you otherwise meet the ownership and ordinarily inhabited rule.

To claim the principal residence exemption, you have to designate a property that qualifies as your principal residence. If more than one property qualifies as your principal residence, the exemption may be claimed for only one property for a particular year. In addition, you or your "family unit" (e.g. a spouse and minor child) may designate only one property as your principal residence for a particular year.

For more information regarding the application of the principal residence exemption for Canadian tax purposes, please ask an RBC advisor for a separate article on this topic.

U.S. tax rules regarding the qualifying home exclusion

Much like the Canadian tax rules, for U.S. income tax purposes, a capital gain triggered when a U.S. person sells a home that has appreciated in value since the date of purchase is taxable; but a capital loss generally isn't deductible on personal use property. Also, determining the gain or loss involves a calculation of the selling price less selling costs less the property's adjusted cost basis. (A discussion of the calculation of the adjusted cost basis for U.S. income tax purposes is beyond the scope of this article.)

If a U.S. person gifts the home or dies owning it, a capital gain isn't triggered. Instead, U.S. transfer tax, including U.S. gift and estate tax,[1] which are not discussed in this article, may apply. A capital gain isn't triggered if the home is transferred to a spouse as part of a divorce settlement unless your spouse isn't a U.S. person for income tax purposes.

1 For more information on U.S. gift or U.S. estate tax, please ask an RBC advisor for a separate article discussing U.S. transfer tax.

When there's a capital gain and the property was owned for less than a year, the capital gain is subject to U.S. tax based on your marginal U.S. income tax rate. The maximum U.S. federal marginal tax rate is currently 37%. However, if the property was held for at least one year, a long-term capital gains tax rate applies. (The long-term capital gains tax rate is based on your income level, with a maximum tax rate of 20%.) In addition, the capital gain is subject to a net investment income tax (NIIT)[2] of 3.8% if your income, defined under the NIIT rules, exceeds certain thresholds, which are based on your income tax filing status. A capital gain may also be triggered if a U.S. person leaves the U.S. tax system and is classified as a covered expatriate.[3]

When a capital gain is triggered on a sale of a qualifying home, a U.S. person can exclude up to US$250,000 of the capital gain (referred to as the "qualifying home exclusion"). The qualifying home exclusion allows a couple who files their income tax return with the filing status of married filing jointly to exclude up to US$500,000 of the capital gain. A capital gain in excess of the qualifying home exclusion is generally subject to U.S. income tax based on whether the gain qualifies as a long-term capital gain or not, and a 3.8% NIIT may also apply.

What is a qualifying home?

For U.S. income tax purposes, to meet the requirements of the qualifying home exclusion, the home has to be the U.S. person's "main home." It's not possible for you to have more than one main home at a time. If you own more than one home, your main home would be the property where you spend more time. For example, in the case where you own a vacation property and a home in the city where you ordinarily live and work, the city home would generally be the "main home." When this distinction is unclear, some other factors that may be considered to determine your "main home" include your home's location relative to where you bank, work and where other family members live. The address you use for postal service, voter registration, tax returns and driver's license or car registration may also be considered.

To determine if you're eligible for the qualifying home exclusion, certain criteria need to be met. The following six factors can help determine your eligibility for the qualifying home exclusion:

- **Automatic disqualification:** U.S persons who trigger a gain on their main home as a result of leaving the U.S. tax system do not qualify for the qualifying home exclusion.

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- **Ownership:** The residence must have been owned by the U.S. person for at least 24 months out of the last five years prior to sale. In the case of married spouses who file jointly, only one of them has to meet this requirement.
- **Residence:** The home needs to have been used as your main home for at least 24 months in the last five years. This residency requirement doesn't have to be 24 months in a row — it can be spread out. Generally, vacations and short lengths of time away from home would still count towards time spent at home. If you become physically or mentally unable to care for yourself, you need to show that your home was your main home for only 12 months out of the five years leading up to the date of sale. Any time you spent living in a care facility (such as a nursing home) during the five-year period counts towards your residence requirement, as long as the facility has a license from a state or other political entity to care for people with your condition. Unlike the ownership requirement, for a married couple filing jointly to get the full exclusion, each spouse must meet the residence requirement individually.
- **Look-back:** A U.S. person is only able to claim the qualifying home exclusion once over a two-year period. In other words, you can't claim the qualifying home exclusion if you've sold a home in the last two years prior to the sale of your existing home and have taken the qualifying home exclusion on the gain on the sale of the prior home.
- **Exceptions:** There are exceptions for certain situations including: separation, divorce, death or government service (e.g. those performed by Service, Intelligence and Peace Corps personnel) during the period of home ownership; when the sale involves adjacent vacant land; you owned a remainder interest in the home; your previous home was destroyed or condemned; or you acquired or relinquished the home in a like-kind exchange (a discussion of these situations and eligibility requirements is beyond the scope of this article).
- **Final determination of eligibility:** If you meet the aforementioned criteria, taking into consideration the exceptions described in the previous paragraph, the gain on the sale of the home may qualify for the full exclusion. In the event the criteria aren't met, a U.S. person may be

2 For more information on the NIIT, please ask an RBC advisor for a separate article discussing U.S. income tax and filing requirements.
3 For more information about leaving the U.S. tax system, please ask an RBC advisor for a separate article discussing exiting the U.S. tax system.

eligible for a partial exclusion if the main reason for your home sale was a change in workplace location, a health issue or certain unforeseeable events (a discussion of which is beyond the scope of this article).

U.S. tax planning for a qualifying home

Compared to Canadian tax rules, the U.S. tax rules provide much stricter guidelines for a U.S. person living in Canada when it comes to excluding the gain from the sale of their main home from U.S. income tax. For example, based on the definition of "main home," a U.S. person doesn't have the ability to claim this exclusion on their vacation property and there's a limit up to US$250,000 (US$500,000 if married filing jointly) of the gain that may be excluded from U.S. income tax.

On the other hand, for Canadian income tax purposes, there's no limit on the amount of the capital gain that may be exempt under the principal residence exemption and the home doesn't need to be your main home; in other words, there's some flexibility in designating your home or vacation property for an exemption from Canadian income tax. Generally, you'd designate a property sold as your principal residence if it has a larger accrued capital gain than other properties that otherwise would qualify if they were sold.

Due to the differences in the U.S. and Canadian tax rules, a married couple where one spouse isn't a U.S. person may benefit by structuring ownership of the purchase of a qualifying home in the name of a spouse who isn't a U.S. person. In addition, strategies for transferring ownership of the home to a non-U.S. person may result in income tax savings if the home is to be sold in the future.

For example, it's common for a U.S. citizen married to a non-U.S. citizen to file their U.S. income tax return separately, selecting the filing status of "married filing separate," because it requires only the U.S. citizen to file a U.S. return and pay U.S. income tax. The U.S. citizen who files separately qualifies for an exclusion amount of up to US$250,000 of the capital gain triggered on the sale of a qualifying main home. If the capital gain on the sale exceeds this amount, the excess will be subject to U.S. income tax. If this couple rebalanced ownership through gifting of the home to the non-U.S. citizen spouse, the capital gain on the eventual sale of the home may avoid both Canadian and U.S. income tax. Keep in mind that the transfer should be made well in advance of listing the home for sale, because if the U.S. tax authorities (based on a review of the facts and circumstances) believe that the transfer was made in contemplation of an imminent sale, they may attribute all or a portion of the capital gain triggered to the U.S. spouse who transferred property. Therefore, it may make sense to structure the ownership

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of your home in the name of a spouse who isn't a U.S. person when it's purchased or otherwise obtained.

The potential U.S. income tax saved on a home that's increased in value by US$1 million would be approximately US$178,500, assuming a 23.8% tax rate (i.e. take proceeds of US$1 million less the US$250,000 exclusion and multiply by 23.8%). It's important to weigh any potential tax savings against costs such as legal fees, potential land transfer tax and probate tax exposure resulting from sole ownership, as well as the U.S. gift tax that may be triggered.

There may also be U.S. estate tax savings by making the transfer on any future growth in the value of the home. U.S. gift tax rules must be considered when a U.S. spouse transfers ownership of the home to a non-U.S. spouse. A discussion of U.S. gift and U.S. estate tax are beyond the scope of this article. If you would like more information, please ask an RBC advisor for a copy of a separate article discussing the U.S. transfer tax system.

Planning for U.S. income taxes on the sale of a main home should be discussed with a qualified cross-border tax advisor.

U.S. taxation of mortgages on a Canadian home or vacation property

For U.S. income tax purposes, a U.S. person may claim a deduction on their U.S. income tax return for the mortgage interest paid on a Canadian home or vacation property if certain criteria are met. There are two options for claiming a deduction:

- If the property is not used to earn rental income, a general deduction may be claimed (referred to as an "itemized deduction") on your individual U.S. income tax return.
- If the home or vacation property is used to earn rental income, it may be possible to claim a deduction of the applicable mortgage interest related to earning the rental income as an expense to reduce the amount of rental income subject to U.S. income tax.

Also, the U.S. income tax laws may levy an income tax on foreign exchange gains associated with changes in the U.S. and Canadian foreign exchange rate when there are repayments or refinancing of a non-U.S. dollar denominated mortgage on a home or vacation property

located in Canada. However, losses due to changes in foreign exchange rates associated with the repayments and refinancing aren't deductible. Furthermore, since a loss on the sale of a home isn't deductible, it cannot offset any taxable exchange gain on a mortgage.

There are special Canadian tax rules that apply when the funds borrowed (including a mortgage on a personal residence or vacation property) are used to earn income from property, which are not discussed in detail in this article. In general, a deduction for mortgage interest related to earning rental income on the property is permitted. However, a deduction for mortgage interest where the property isn't used to earn rental income or the borrowed funds aren't used to earn other forms of income from property is not permitted.

The following sections describe the U.S. tax rules regarding the deduction of mortgage interest paid on a Canadian home or vacation property and the taxation of foreign exchange gains and losses for non-U.S. dollar denominated mortgages.

Deduction of Canadian mortgage interest on your U.S. income tax return

Mortgage interest and interest on other types of qualified home debt may be deductible for U.S. income tax purposes as an itemized deduction when it relates to a qualifying home that a U.S. person has an interest in, and the home is their main or second home. The interest on the home debt must be secured on a qualifying home and used to buy, build or substantially improve your main home or a second home. Itemized deductions are qualified expenses that reduce your taxable income, which you may elect to claim instead of a standard deduction that you otherwise may be eligible to claim under the U.S. income tax laws.

A qualifying home is typically your main home or a second home which may include a house, condominium, cooperative, mobile home, house trailer, boat or a property which has toilet, cooking and sleeping amenities. In addition to the mortgage having to be secured against a qualifying home, the borrower needs to be liable for the debt and pays the interest on the qualifying home.

In the case of a U.S. person who files their income tax return as married filing separately, you may deduct up to US$375,000 of mortgage interest or other debt interest incurred on a qualifying residence (or up to US$750,000 for married filing jointly). Since the limit applies to all debts secured on the qualifying home, provided they are used to buy, build or substantially improve your main home or a second home, where a mortgage or home equity line of credit is used for personal expenses, the associated interest paid is typically not deductible.

If you're a U.S. person and you make a mortgage payment or refinance a non-U.S. dollar denominated mortgage on a property located outside the U.S., any foreign exchange gain related to the amount repaid or refinanced is subject to U.S. income tax.

It's important to note that you're subject to Canadian and U.S. income tax on your worldwide income, and foreign tax credits may be claimed to minimize or eliminate double tax. Since Canadian income tax rates are generally higher than U.S. income tax rates and are applied at much lower taxable income levels, if all or most of your income is earned from Canadian sources, you may have sufficient foreign tax credits arising from the Canadian tax you paid to offset your U.S. taxes (with the exception of U.S. NIIT levied, which cannot be reduced by foreign tax credits).

You should discuss with a qualified cross-border tax advisor whether there is any additional benefit for a U.S. person living in Canada to claim a mortgage interest deduction on their U.S. income tax return.

U.S. taxation of foreign exchange gains and losses on your Canadian mortgage

If you're a U.S. person and you make a mortgage payment or refinance a non-U.S. dollar denominated mortgage on a property located outside the U.S., any foreign exchange gain related to the amount repaid or refinanced is subject to U.S. income tax. For U.S. persons with Canadian property and Canadian dollar-denominated mortgages, there will generally be a foreign exchange gain if there's an increase of the U.S. dollar from the mortgage origination date to the repayment date because you'll need fewer U.S. dollars to repay in Canadian dollars.

The foreign exchange gain is calculated by multiplying the difference between the exchange rates (when the mortgage was acquired compared to when repaid) by the amount repaid. The exchange gain is taxed as ordinary income. If a U.S. person has excess foreign tax credits available, it may be possible to eliminate the U.S. income tax on the foreign exchange gain.

Where there's a foreign exchange loss, which would arise if the U.S. dollar depreciates against the Canadian dollar, the loss cannot be used to offset capital gains (e.g. on the sale of the home) because it's considered a personal non-deductible loss for U.S. income tax purposes. The loss also isn't eligible for the excess capital loss of up to US$3,000 ($1,500 if married filing separately) that may be claimed annually.

Summary

As a U.S. person living in Canada, having an awareness of both the Canadian and U.S. tax implications related to ownership of your Canadian home or vacation property is important. Building an understanding of the U.S. tax implications may help you to explore potential tax planning strategies with a qualified cross-border tax advisor to minimize your U.S. tax exposure and help you reduce the potential for unexpected tax issues.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified cross-border tax, legal and/or insurance advisor before acting on any of the information in this article.



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