

Owning Property Abroad

Presented by: Jordan Kennedy, CPA, CA

1

Outline for Today

1. Types of Property
2. Tax Differences – Domestic vs. Foreign Property
3. Foreign Property – Required Annual Disclosures
4. Annual Income Tax Implications
5. Tax Implications on Disposition
6. Tax Implications on Death
7. Principal Residence Exemption
8. US Property
9. US Estate Tax

2

Types of Property

Depending on the intent/use of the property, it may be considered:

I. Capital Property
- Personal-use property (i.e. cabin, artwork); or
- Investment property (i.e. rental house, securities)

II. Income Property
- Inventory/adventure in the nature of trade (i.e. house flip)

Regardless of whether the property is located in Canada or abroad, the tax implications will first depend on whether the property is considered to be held on account of income or capital

3

Tax Differences

Foreign vs. Domestic Property

- The Income Tax Act generally taxes domestic and foreign property the same
- The main difference between how domestic property and foreign property is taxed relates to the foreign taxes paid on the income/gain on the property and the availability of foreign tax credits to offset the Canadian income tax on this same income/gain
- Canada has tax treaties with most economically stable countries which generally encourage the movement of capital between them and attempt to mitigate the potential for double taxation
- Aside from any taxation differences, foreign property does have more onerous annual reporting requirements to CRA

4

Tax Treaties

Purposes:

- Avoid double taxation and prevent tax evasion
- Define which taxes are covered and who is a resident and eligible for the benefits
- Limit withholding tax on interest, dividends and royalties
- Limit tax on business income to income from a permanent establishment
- Define circumstances in which income of individuals resident in one country will be taxed in the other country on salary, self-employment, pension and other income
- Provide exemption for certain types of organizations or individuals
- Provide framework for enforcement and dispute resolution

5

Foreign Property Disclosure

Form T1135 – Foreign Income Verification Statement

- Required to be filed for any taxation year in which you own specified foreign property (i.e. real property, securities, etc.) with an aggregate original cost greater than $100,000 CAD
- More detailed reporting required where the cost of specified foreign property exceeds $250,000 CAD
- Must be filed annually by all taxpayers resident in Canada - i.e. individuals, corporations, partnerships, trusts, etc.
- Form has been updated and expanded with significant additional disclosures now required
- Significant penalties for non-compliance – maximum of $2,500 for each failure to file

6

Foreign Property Disclosure

Form T1135 – Foreign Income Verification Statement

- Form can be filed electronically, but separate from the actual income tax return… it is not filed automatically with electronic returns
- Disclosures required include property description, original cost, country located in, income/gain/loss in current year, etc.
- Property used exclusively for personal use (i.e. vacation home in Phoenix) does not need to be disclosed on T1135
- Consider filing under CRA voluntary disclosure program to avoid penalties in cases of deficient filings going back multiple years (must be at least one year past due)

Annual Income Tax Implications

Foreign Property Income/Loss

- Often the income/proceeds of disposition are subject to a foreign withholding tax (similar to that which Canada levies)
- Typically, the taxpayer will file an annual income tax return with the foreign country to report the income/expenses and ensure that only the actual net profit is subject to foreign taxation
- Some countries allow for a lower withholding tax on the income/proceeds of disposition based on certain exceptions/elections (i.e. net profit/gain withholding tax waiver)
- This may alleviate the need/benefit of having to file a foreign income tax return

Annual Income Tax Implications

Foreign Property Income/Loss

- The identical income/expense information reported to the foreign country is generally what is required to be filed on the taxpayer's Canadian income tax return subject to conversion into CAD using the average annual exchange rate
- The cost of the property may be depreciated for Canadian tax purposes (CCA claims) based on the actual f/x rate at the time of acquisition
- There is no requirement to recognize the annual unrealized f/x gain/loss on the property
- The eventual capital gain/loss recognized on disposition of the property will take into account both the change in underlying value of the property and the f/x difference between acquisition and disposition

ACCOUNTING › CONSULTING › TAX MNP.ca

9

Annual Income Tax Implications

Foreign Property Income/Loss

- Any foreign taxes paid on the income/gain will qualify for a foreign tax credit on the Canadian income tax return
- The foreign tax credit allowed is essentially the lesser of the actual foreign taxes paid and the proportionate share of Canadian income taxes triggered <u>on that same income</u>
- Foreign taxes paid can only shield Canadian income taxes from the same property and not any other sources of income
- To avoid the potential for double tax - the lower the actual foreign taxes paid, the better (so that no foreign tax credits go unutilized)
- Foreign tax credits are calculated on a country by country basis

ACCOUNTING › CONSULTING › TAX MNP.ca

10

Annual Income Tax Implications

In Summary

- Foreign property income/gains are taxed the same as domestic property income/gains with the added complexity of converting all amounts into CAD and claiming the applicable foreign tax credits
- In order to substantiate the foreign tax credit, documentation should be retained showing the foreign withholding taxes and/or the foreign tax return filed evidencing the actual tax liability

11

Tax Implications on Disposition

Foreign Property Gains/Losses

- Regardless of intent/use of property the gain will be taxable in Canada provided the principal residence exemption is not utilized
- If the property is held for investment/rental purposes, any capital loss will be recognized
- If held strictly for personal use, any capital loss is non-deductible
- Capital losses are carried forward indefinitely and may only be used against future capital gains except for the year of death/preceding year where they may be claimed against any source of income subject to certain restrictions
- Foreign tax credits on disposition may be claimed to offset Canadian taxes on the capital gain
- Deemed disposition at fair market value is triggered on death, gifting to children, emigration, etc.

12

Tax Implications on Death

Foreign Property Gains/Losses

- Deemed disposition at fair market value immediately prior to death
- Tax-deferred spousal rollover generally available
- If foreign taxes apply it may be beneficial to elect out of the spousal rollover to make use of the foreign tax credit/bump up the tax cost of the property
- Non-spouse beneficiaries will inherit the property with new tax cost equal to fair market value

13

Principal Residence Exemption

- May be claimed against foreign property, however often not advantageous to do so where taxpayer also owns Canadian property which could be designated as such since foreign tax credits would be wasted
- Is a designation made independently each year and after the fact so have the power of hindsight to some extent
- Extra year in formula so it is may be beneficial to designate at least one year to each property held
- Requirement is simply that the property is inhabited by the taxpayer occasionally during the year – i.e. “principal” is a misnomer

14

US Property

Rental Property

- 30% federal withholding tax applies to gross rents unless net income withholding tax election filed
- No requirement to file annual tax return (unless above election is made) but it may be advantageous in order to carry forward losses to offset the eventual gain on sale
- Unlike in Canada, depreciation is a mandatory annual deduction for US tax purposes

ACCOUNTING › CONSULTING › TAX   MNP.ca

15

US Property

Dispositions of Real Property

- 15% federal withholding tax applies to gross proceeds on sale unless waiver to withhold on net gain is received in advance
- State withholding taxes may also apply similar to federal requirements just at lower rates
- Required to obtain tax filer ID number and file US federal and state (if applicable) tax returns for year of disposition

ACCOUNTING › CONSULTING › TAX   MNP.ca

16

US Property

Other Ownership Structures

- Cross-border irrevocable trust can avoid US estate tax (discussed later) and state probate
- Contributing spouse would be the settlor, other spouse would be the trustee and a beneficiary, kids and grandkids are the other beneficiaries
- Low 20% capital gains rate (US) can be achieved on disposition
- Contributing spouse (settlor) can use the property, but only at the sufferance of the beneficiary spouse

17

US Estate Tax

- Increased exemption is now $11.4M (after 2018 US tax reform), with a top tax rate of 40%
- If your estate exceeds $11.4M, US estate tax may apply and the exemption will be prorated based on US situs assets/worldwide assets
- Additional “marital credit” for spousal rollovers is available
- US estate tax is eligible to be claimed as a foreign tax credit for Canadian federal tax purposes on deemed disposition on death subject to limitations
- US estate tax won’t apply where property is held via a corporation, partnership or trust but post-mortem tax planning may be required to unwind the structure to avoid the potential for double tax going forward (i.e. Canadian single purpose corporations)

ACCOUNTING › CONSULTING › TAX MNP.ca

18

Legal Stuff

<u>Disclaimer:</u> This presentation is provided for information purposes and is intended for general guidance only. It should not be regarded as comprehensive or a substitute for professional advice. Tax law is subject to continual change, at times on a retroactive basis. Before taking any particular course of action, contact your MNP advisor to discuss these matters in the context of your particular situation.

Contact Info

Jordan Kennedy, CPA, CA
MNP LLP
800, 119 4th Avenue S
Saskatoon, SK S7K 5X2

Jordan.kennedy@mnp.ca
306.665.6766

Questions?

ACCOUNTING › CONSULTING › TAX MNP.ca

21