

# Message to Canadian Owners of US Rental Properties: The IRS is Going to be in Your Neighbourhood

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In a recent research [study](#), the US Department of the Treasury identified a considerable number of non-resident aliens (NRAs) who were not reporting income from US rental properties or who were reporting their rental income as taxable on a net basis without making the mandatory election to treat these rentals as a US trade or business. The Internal Revenue Service (IRS) responded by announcing that a new enforcement campaign will be rolled out later this year, with the Commissioner of the IRS declaring that NRAs can expect notices regarding their filing deficiencies and the penalties and interest associated with those. For Canadians who own US real estate that they rent out, it is thus increasingly important that rental income be properly reported, even if the rental is infrequent.

## The Problem:

The study focused on NRAs who own US real estate and generate rental income from these US properties. Generally, NRAs who earn rental income from US real estate are subject to a flat 30% tax on the gross rent, which is required to be withheld and remitted to the IRS by the tenant, property manager, or other withholding agent that has control over the property. The NRA owner may, alternatively, make an election to treat the rental income of the property as effectively connected with a US trade or business and certify to the payer that he or she is electing to be taxed in this manner. The election has two principal benefits: (1) it creates ability to deduct expenses related to the rental activity; and (2) it allows the owner to take advantage of graduated income tax rates as opposed to the 30% flat tax rate on the rental income. It also eliminates the need for the tenant to withhold tax, though it does require the filing of a US tax return by the non-US owner. US federal tax on rental income should generally be creditable on a Canadian resident's Canadian tax return, as are state and local income taxes that may apply.

## The Solution:

Our recommendations for an NRA who owns real estate in the US and generates rental income from that property are as follows:

- Initiate discussions with a qualified US tax advisor prior to an IRS audit; and
- Develop appropriate and advantageous compliance strategies going forward.

The Commissioner of the IRS has made it clear that he is concerned about the findings from the study, and the IRS will be investigating situations where it suspects non-compliance by NRAs. If you are a NRA who owns rental properties in the United States and have not been current with your tax filings, it's a good time to discuss your facts and circumstances with a qualified tax advisor to determine the best approach of getting current, and to obtain proper documentation in case of audit by the IRS. In addition to setting the record straight with the IRS, you will need to be mindful of interest owed on unpaid tax and any potential penalties.

Making an election to treat the rental income of the property as effectively connected to a US trade or

business as discussed above certainly has its benefits, but it is not the only option an NRA has. Depending on your circumstances, it might make sense to hold your rental property in a US corporate entity. A US corporation is a blocker for US income tax purposes and provides personal liability protection. As a result of a tax reform, US corporations are subject to a flat 21% federal tax rate and using one may extend E-2, Treaty Investor, Non-immigrant Visa eligibility to the property owners and certain non-US citizen personnel. A Canadian corporation would be subject to the same rates as a US corporation and can also provide protection against the US estate tax, though holding personal use property in a corporation can be problematic under Canada's shareholder benefit rules. In addition, the possible application of Canada's "FAPI" regime ("foreign accrual property income") would need to be carefully reviewed.

There are many issues to consider when investing in US real estate and Canadians should be aware of the tax consequences at every stage of the investment from, owning the property, renting the property, reporting requirements on both sides of the border, to eventually selling it. It is clear that—for now—anyone renting out US real estate will be subject to closer scrutiny by the IRS.