

## Rental of U.S. Real Estate

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Canadians who intend to rent their vacation home or secondary residence situated in the U.S. are subject to a U.S. withholding tax of 30% on the gross rental. The agent who collects the rent is responsible to remit the tax to the IRS. Any U.S. tax payable is creditable on your Canadian tax return.

A waiver from withholding is available by providing the agent with IRS Form W8-ECI. This form is required to be filed with the agent every 3 years. The completion of the W8-ECI obligates the individual taxpayer to make a special election with the filing of a U.S. tax return (U.S. 1040NR for each individual co-owner due June 15 of the following year), to report your net rental income and pay U.S. tax based on graduated tax rates. Some States will require the filing of a State non-resident tax return. The W8-ECI requires a U.S. identification number such as an individual taxpayer's identification number ("ITIN") for individual owners or an employer's identification number ("EIN") for corporate owners. The management company may withhold until they receive the ITIN. Withholding will be reported on an IRS tax information slip for you to claim credit on the tax return.

Net rental income is gross rentals less expenses less U.S. depreciation on the building and on furniture & fixtures. If there is a loss on the property, the loss is available for carry forward and may be applied against capital gains realized on the sale of the property. Any U.S. tax payable is creditable on your Canadian tax return.

In order for the tax return to be accepted by the IRS or the W8-ECI to be accepted by the management company, you will need an ITIN or an EIN. The ITIN is applied for by completing IRS Form W-7. The application is attached to your first tax return if it is not applied for earlier as outlined below. With changes to the ITIN process since June 22, 2012, you need to attach a certified copy of your passport from the Canadian passport office, otherwise you would submit your passport. An IRS Acceptance Agent may speed up the process by attaching his/her certificate of accuracy IRS Form W-7(COA) to the package and in most cases, with a photocopy of the passport attached to the W-7. The Canadian Passport Agency is now charging for certified copies of passports.

On June 30, 2014, the IRS announced that they will not deactivate an ITIN that has not been used on at least one return in the past five years. This means that if you don't file a tax return in a 5 year period, the ITIN will be deactivated. This could happen if you are not up to date with your rental filings or if you purchased a property from a non-resident of the U.S. and you do not sell after 5 years. It was previously proposed that ITINs would be issued for a period of 5 years with a renewal process. The EIN is applied for by completing IRS Form SS-4 which may be applied for over the phone with the IRS.

If you wish to obtain the ITIN after you acquire the property or before receipt of the first rental, you may meet "Exception #1(d)" as outlined in the instructions for completing the W-7. The withholding agent must write a letter on their letterhead, on your behalf stating that an ITIN is required to make distributions to you during the tax year with is subject to IRS reporting and federal tax withholding. This letter, one for each co-owner, should be attached to the W-7. After you obtain the letter from the agent, you should provide them with the W-8ECI as discussed earlier. The agent will issue a 1099-Misc reporting slip indicating the gross rental and withholding made on your behalf. If you did not provide the W8-ECI, you may receive a 1042-S reporting slip which is issued to a foreign rental recipient.

For those who do not use a management company or withholding agent, the W8-ECI should be provided to your tenant as the tenant is effectively the payor of the rent subject to the 30% withholding requirement. We have determined that the ITIN office will not issue an ITIN prior to filing the first tax return to those who rent the property themselves as opposed to using a third party management company.

Conversation with the IRS has also conveyed that a self-rental activity is personal in nature and does not require the issuance of the 1099-Misc reporting slip. However the income is still reported with the filing a tax return if the election is made with the return to treat the income as ECI. Technically the potential exposure is to the tenant in that a W8-ECI provided to your tenant that does not have an ITIN written on it, as opposed to "Applied For", may not be sufficient to eliminate the withholding requirement for the period in which the ITIN has not been issued. If you can not obtain the ITIN before the filing of the first tax return with respect to a self-rental, you should be prepared to compensate the tenant for any IRS penalties for not withholding the 30% during this interim period.

The W8-ECI obligates the owner to file a return that treats the gross rental income as ECI if the appropriate election is made with the tax return. If in the first year, there is no gross rental income, the election can not be made and otherwise deductible expenses are lost for that year. For the first year in which there is gross rental income, the election can be made for that year and is effective for all rental properties in subsequent years, regardless of any gross rental income, unless it is revoked by the taxpayer.

If the property is held as joint owners or as tenants in common, each party must complete the foregoing tax forms.

If the property is held by a Canadian corporation, a partnership, a trust or an estate, similar rules may apply.

U.S. forms are available on the IRS website (at <http://www.irs.ustreas.gov/pub>).

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*Contact your professional advisor prior to implementing any of the outlined strategies*

### **Internal Revenue Service Circular 230 Disclosure**

*Pursuant to Internal Revenue Service Circular 230, we hereby inform you that the advice set forth herein with respect to U.S. federal tax issues was not intended or written to be used, and cannot be used, by you or any taxpayer, for the purpose of avoiding any penalties that may be imposed on you or any other person under the Internal Revenue Code.*

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