# XBlox News for Americans

ISSUE # 3

## WHAT CANADIANS NEED TO KNOW ABOUT THE IRS' POTENTIAL CRACKDOWN ON FOREIGN PROPERTY OWNERS

If you're a Canadian who owns U.S. residential real estate, now may be a good time to ensure you are compliant with U.S. tax laws as the IRS may soon be cracking down on non-compliant property owners based on a report issued by the Treasury Department. The report looked at property ownership by non-residents who should be paying tax on rental income of U.S. property.

Many U.S. vacation property owners either rent or at least attempt to rent out the property when not occupying it. If so, the rental income that is earn may be taxed in both the U.S. and Canada.

In Canada, we pay tax at graduated federal/provincial tax rates on worldwide income, including rental income from a U.S. property, after deducting applicable expenses. You can generally claim a foreign tax credit on your Canadian tax return for the U.S. income taxes that have been paid to reduce the tax that will be payable in Canada.

For U.S. tax purposes, a 30% U.S. withholding tax applies to gross rental income that you earn from your U.S. property. The tenant of your property is required to withhold the tax and remit it to the U.S. tax authorities on your behalf. You may, however, elect to have the rental income treated as 'effectively connected to a U.S. trade or business." By making this election, non-resident aliens (generally non-U.S. citizens) can reduce their rental income by offsetting rental income with various expenses associated with the rental activity, such as property taxes, insurance etc. The net rental income will be taxed at graduated U.S. federal tax rates. State income taxes may also apply.

The report looked at non-resident alien individuals, such as Canadians, who both own and derive rental income from U.S. residential real estate. Currently, the IRS does not ensure that foreign taxpayers properly make the necessary election before being allowed to pay tax on a net basis rather than on the gross rental income. Just over two-thirds of non-resident aliens who rented their U.S. property in 2013 (68%) reduced their gross rental income when reporting the rental activity without complying with the technical, legal requirement of applying for this tax benefit by submitting an election statement. Some non-resident aliens (13%) are not reporting any rental income from U.S. property they own.

To solve this, the report recommended that the IRS improve compliance checks for ensuring that election statements are made. In response, the IRS agreed to revising Form 1040NR, U.S. Nonresident Alien Tax Return for non-resident aliens to make the election. The IRS will also be revising its processing procedures to ensure that the election is recorded. And, of most concern to non-compliant landlords, the IRS also agreed to develop a compliance initiative addressing foreign property owners who do not report rental income generated by real property they own in the U.S.

Note that even if you don't rent out your property, when you sell it, you may face a tax bill in both Canada and the U.S. on any appreciated value. A capital gain arises if the proceeds from disposition, net of selling expenses, exceed the cost of the property, including any amounts paid for capital improvements.

Currently, the maximum U.S. federal long-term capital gains tax rate is 20%. You would pay the long-term capital gains tax rate provided you owned the property for more than one year prior to the sale. If you owned the property for one year or less, graduated U.S. federal income tax rates (with a top rate of 39.6%) would apply to short-term capital gains. State taxes may also apply.

In the U.S., the purchaser is generally required to withhold 15% of the gross proceeds when the seller is Canadian. (If the purchaser acquires property for use as a residence, no withholding is required when the proceeds of sale are under US$300,000 and a 10% rate applies for proceeds up to US$1 million. You may apply to the IRS for a withholding certificate that would allow withholding taxes to be reduced or eliminated, such as when the ultimate income tax liability is expected to be less than the withholding amount. You may generally claim the withholding tax as a credit against any tax owing when you file a U.S. tax return.

For Canadian tax purposes, the disposition of your U.S. property must also be reported on your Canadian tax return. The gain is 50% taxable at your marginal tax rate and you can claim a foreign tax credit for any net U.S. tax paid on the capital gain to reduce your Canadian liability so you don't end up paying tax twice.

## DESPITE RECORD NUMBER OF U.S. EXPATS MEETING FILING REQUIREMENTS, 7 OF 8 STILL LIKELY NONCOMPLIANT

The IRS noted almost 1.2 million expats filed a Report of Foreign Bank and Financial Accounts (FBAR) in 2015, an 8 percent increase from the previous year. That still leaves a number of the estimated 8.7 million U.S. citizens living abroad in violation of the United States' unique and perhaps still unfamiliar tax requirements, which impact more taxpayers than may be aware of them.

| Living | Must File | If |
|---|---|---|
| anywhere in the world | a tax return | they meet the normal filing threshold. |
| | an FBAR | they have foreign bank or other financial accounts totaling $10,000 or more at any point of the year. |
| outside the U.S. | form 8938 | their specified foreign assets exceed $200,000 ($400,000 for joint filers) at the end of the year or ever exceeds $300,000 during the year ($600,000 for joint filers). |
| inside the U.S. | form 8938 | their specified foreign assets exceed $50,000 ($100,000 for joint filers) at the end of the year, or ever exceeds $75,000 during the year ($150,000 for joint filers). |

"Expats who have moved abroad may be surprised to learn they still have a U.S. tax filing requirement, but they aren't the only ones. U.S. citizens who have never lived in the U.S., U.S. citizens who are living abroad temporarily and foreign nationals living in the United States may all have different IRS reporting obligations.

United States citizens or residents who own or control foreign financial accounts must file an FBAR if the foreign financial accounts' combined value exceeds $10,000 at any point during the year. They should submit the form to the Department of Treasury through the BSA e-filing system by June 15. They may also need to include foreign asset information with their tax return (due June 15 for taxpayers who are abroad) on Form 8938, Statement of Specified Foreign Financial Assets.

## BEWARE IRS AUDITS OF OFFSHORE ACCOUNT FILINGS

Perhaps you only recently became aware that the IRS wants you to report your worldwide income on your taxes, and (separately) to report your foreign accounts. Perhaps you only woke up to it because of FATCA, the massive 2010 American tax law that took effect in countries and banks worldwide June 1, 2014. If this is all new to you, you have

some catching up to do. The IRS has been pushing hard for nearly a decade, and it is becoming harder to claim ignorance.

The gasping and scrambling largely started in 2009. The IRS and Justice Department took on Swiss banking, and in 2008, started to win big in court. With huge potential exposure for helping Americans, on February 18, 2009, UBS settled with the U.S. government for a fine of $780 million. Since then, vast numbers of Swiss and other banks have either faced criminal charges or settled with big civil settlements. And American taxpayers have too. There have been several different IRS ‘amnesty’ programs to encourage individuals to come forward. Until mid-2014, most people were resigned to the Offshore Voluntary Disclosure Program, or OVDP. At this point, the IRS offshore account collections haul has topped $10 billion, and it isn’t over yet.

But there has been one huge change, and it has ominous possibilities for the future. A mid-2014 announcement of domestic and foreign Streamlined programs radically changed the playing field. Rather than 8 years of tax returns and FBARs, with taxes, penalties and interest (OVDP), the Streamlined program involves filing 3 tax returns (plus 6 FBARs) and paying taxes and interest.

Financially, the comparison can be stark. Understandably, many taxpayers have an easier time deciding to file Streamlined rather than OVDP. The biggest difference is the overall asset-based penalty. In the OVDP, the penalty is 27.5% or even 50% of the highest balance (over 8 years) of the non-declared funds/assets. In contrast, Streamlined filers pay either 5% or zero. Those residing outside the United States, pay no penalty. While Streamlined filers in the U.S. pay 5% of the foreign accounts/assets.

In some ways, the IRS gives you what you pay for. The OVDP precludes criminal prosecution and ends in a closing agreement. In contrast, Streamlined filers can face a civil audit or conceivably even prosecution. Prosecution may be highly unlikely, provided that the taxpayer cooperates if the IRS audits, but that audit may not be easy. A key for any Streamlined filer is to be non-willful. One must certify that. Negligence, inadvertence, or mistake are all OK, but intent to conceal or to evade taxes is not. The certification requires the taxpayer to:

Provide specific reasons for your failure to report all income, pay all tax, and submit all required information returns, including FBARs. If you relied on a professional advisor, provide the name, address, and telephone number of the advisor and a summary of the advice. If married taxpayers submitting a joint certification have different reasons, provide the individual reasons for each spouse separately in the statement of facts.”

You may believe your inadvertence was non-willful, but the IRS may not agree. And the IRS has a treasure trove of data now. If you knew you were supposed to report, the IRS may say you were willful. What’s more, the IRS uses a concept of “willful blindness.” Essentially, it is a conscious effort to avoid learning about the IRS or FBAR reporting. Willfulness involves a voluntary, intentional violation of a known legal duty. In taxes, it applies for civil and criminal violations. The failure to learn of filing requirements, coupled with efforts to conceal the facts, can spell willfulness. Watch out for conduct meant to conceal, such as:

- Setting up trusts or corporations to hide your ownership.
- Filing some tax forms and not others.
- Keeping two sets of books.
- Telling your bank not to send statements.
- Using code words over the phone.
- Cash deposits and cash withdrawals.
- Moving money from one bank to another when banks don’t want undisclosed American accounts.

**Ho Ho Ho!**

**Have a Merry Christmas and a Happy New Year!**