THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Filing taxes on both sides of the U.S.-Canada border takes special planning

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED OCTOBER 4, 2023

I was visiting a neighbour, Rhonda, this past weekend. She's a U.S. citizen who's been living in Canada for many years and has to file a tax return in both countries.

"Last year, I filed my U.S. tax return electronically to speed things up, and it worked – I got an audit letter in half the time," she told me. Rhonda's 2022 U.S. tax return is due on Oct. 16 (the deadline for most returns if an extension request has been filed).

I also learned that Rhonda sold her cottage in Canada last year, which complicates her tax filings for 2022. When you're resident in Canada and also have to file tax returns in the U.S., the rules on both sides of the border matter and are different enough to potentially cost you plenty of dollars without good planning.

CPP, OAS and RRSP tips for those working in their 70s

The differences

I was telling Rhonda that the sale of her cottage can be tax-free in Canada. Under our rules, she can designate her cottage as her principal residence if she "ordinarily inhabited" the place, which means that she only needed to stay in her cottage for a short period of time each year – which she did.

She also owned the property for several years, so she doesn't have to worry about the new property flipping rule in Canada that would deny the principal residence exemption if she owned the place for less than 12 months. Rhonda did claim the PRE on her cottage sale when she filed her 2022 Canadian tax return last April.

Unlike our Canadian rules, which can allow Rhonda to shelter the full gain on her cottage, the tax rules in the U.S. will allow a taxpayer to exclude up to just US$500,000 in gains on the sale of a residence if the taxpayer files jointly with a spouse. The amount is $250,000 if a person files single, head of household or married filing separately. Rhonda is single, so she only gets a $250,000 exclusion in the U.S. – if her cottage qualifies.

Another limitation in the U.S. is that the property must generally qualify as a principal residence for two of the last five years prior to the sale to be eligible for the exclusion.

In Canada, it's not uncommon for more than one property to qualify as your principal residence because you can "ordinarily inhabit" more than one property – although you can only designate one property as your principal residence for each tax year. In the U.S., there is no "ordinarily inhabited" test, and having more than one residence, such as Rhonda, can be a problem.

In the U.S., if someone alternates living between two properties, the property that the taxpayer uses the majority of the time during the year will normally be considered their principal residence.

In addition to use of the property, the U.S. tax law identifies the following six factors as relevant when determining which property is a principal residence: the taxpayer's place of employment; the principal place of abode of the taxpayer's family members; the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration and voter registration card; the taxpayer's mailing address for bills and correspondence; the location of the taxpayer's banks; and the location of religious organizations and recreational clubs with which the taxpayer is affiliated.

In Rhonda's case, it's not hard to see that her cottage isn't going to qualify as her principal residence for U.S. tax purposes even though it will in Canada. The result: She can avoid tax in Canada but not in the U.S. on the sale.

Two smart RRIF strategies to consider as part of your estate planning

Seven tax-saving ideas to consider before year-end

The nuances

When planning for taxes on both sides of the border, it's important to avoid a situation where a sale is tax-free in one country but not the other. In an ideal situation, you'll be able to claim a foreign tax credit in one country for the taxes paid in the other country. To do this, it's important that the property be taxable in both countries in the same tax year.

In Rhonda's situation, she won't be able to claim a foreign tax credit in Canada for the U.S. taxes paid because she didn't pay any taxes in Canada on the sale. This mismatch creates a potential for additional tax when the second property – her city home – is eventually sold.

To solve this, Rhonda is going to amend her 2022 Canadian tax return to cause the cottage to be taxable (by not using her PRE) and will then partially offset that tax with a foreign tax credit for the U.S. taxes paid on the sale.

The bottom line: Anyone taxable in more than one country should get tax advice when major life events, or the sale of assets, takes place.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc. He can be reached at tim@ourfamilyoffice.ca