Buyer Beware: The sale of your principal residence may not be tax free after all

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Most homeowners in Canada know that when they sell their principal residence, any resulting gain will not be subject to tax in Canada. The "principal residence exemption," the basis for this tax-free disposition, can generally be claimed by an individual so long as he or she owned the principal residence and lived in it. While the exemption's application can be tricky sometimes – when multiple properties are owned, or when principal residences are owned for a short period of time, for example – the principal residence exemption claim is fairly straightforward in most circumstances.

What many homeowners in Canada don't know, however, is that while the sale of a principal residence may be tax-free in Canada, tax may be owing in the US on the disposition of a principal residence by a US citizen living in Canada. US citizens, no matter where they live, are taxed on their worldwide income, and only the first $250,000 gain on a sale of a principal residence will be free of tax in the US. Any gain in excess of this amount will be taxed in the US at a rate of up to 24%, assuming the property has been held for more than one year and has not been used as a rental residence. This is a rude awakening for many US citizens living in Canada who, if the circumstances permitted, might have otherwise been able to avoid such tax. The good news is that it still may not be too late.

The easiest way for US citizens to avoid US taxes on the sale of a principal residence is, of course, for the US citizen to not have owned the principal residence in the first place. Where, for example, a US citizen living in Canada is married to a non-US citizen, title to the principal residence can be taken from the outset in the name of the non-US citizen spouse only. This planning, however, would have had to be implemented at the outset.

If the US-citizen spouse already owns the principal residence in his or her name, either wholly or partially (i.e., as joint tenants or tenants-in-common), there are steps that may be taken to avoid the US tax altogether. One such way would involve a gift by the US-citizen spouse of his or her interest

in the principal residence to the non-US citizen spouse. The gift could occur in Canada without the incurrence of any income taxes and, unless other consideration passed in connection with the gift, there would not be any land transfer tax in Canada, either. From a US tax perspective, the subsequent sale by the non-US citizen spouse of the principal residence will not result in any US income taxes either so long as the Internal Revenue Service does not “step” together the gift followed by the sale. While the gift of the US citizen spouse’s interest in the principal residence to a non-US citizen spouse may not result in US taxes at the time of the gift, such gift would result in a reduction in the US citizen’s US estate tax exemption upon death.

Generally, US estate taxes are levied on the death of its citizens, regardless of their residency, based on the value of their worldwide estate. (US estate implications for non-US citizens are ignored for the purposes of this article.) In 2023, US citizens are entitled to an exemption from US estate tax on the first $12.92 million of worldwide assets they own, and any assets owned in excess of this amount are subject to US estate taxes at a rate of up to 40%. The US estate tax regime works hand-in-hand with the US gift tax regime so that gifts made by US citizens during their lifetimes in excess of annual exemptions ($175,000 for spouses and $17,000 for children) are exempt from tax up to a certain lifetime limit ($12.92 in 2023), but each such gift in excess of the annual exemptions causes a corresponding deduction to the individual’s US estate tax exemption on death.

By way of an example, Casey is a US citizen living in Canada and his assets include a 50% interest in his principal residence that he owns with his wife, Joan, a non-US citizen. Casey obtained his interest in the principal residence for $1 million, but it is now worth $2 million.

Casey and Joan have decided to sell their principal residence. If steps are not taken prior to the sale of the principal residence, US taxes of up to $180,000 will arise upon its sale. If Casey, however, gifts his interest in the property to Joan prior to its sale, he may be able to avoid this $180,000 of taxes in its entirety – albeit at the expense of a reduction to his US estate tax exemption upon death in an amount equal to the fair market value of his interest in the principal residence. This reduction, however, is unlikely to have any effect on Casey’s estate as he would have otherwise used the proceeds from the sale to either purchase a replacement residence and/or invested them otherwise and, as a result, his estate would – absent any other planning - be left with the $2 million of assets upon his death.

If the sale of Casey and Joan’s principal residence was not imminent, one alternative that they may wish to consider – instead of an immediate gift of the entire interest in the principal residence - involves an annual gift by Casey to Joan of a portion of his interest in the principal residence valued at the annual exemption available for spouses. Each annual gift of a $175,000 interest in the principal residence (the annual spousal gift exemption in 2023) will reduce Casey’s US estate tax exposure by up to $70,000, and after 12 years (ignoring any increases in the principal residence’s value in each year), Casey will have divested himself of all of his entire interest in the principal residence. If the principal residence was then sold, there would be no resulting US taxes and, as a

bonus, Casey's estate will have relieved itself of up to $800,000 of US estate taxes that would have otherwise been owing upon his death. Even if the principal residence was sold in year five of the strategy, for example, the five annual gifts will have resulted in up to $350,000 of US estate taxes savings upon death. Prior to that sale in year five, Casey could gift all of his remaining interest in the principal residence to Joan, potentially resulting in the avoidance of the balance of US taxes that would have otherwise arisen upon the sale of the principal residence.

As with any estate plan, the facts of each particular circumstance must be considered. If you or anyone you know is a US citizen and owns an interest in your/his/her principal residence, it would be incumbent upon you or the other person to consider your/his/her options carefully.

If you have any questions or would like information on tax, estate, or succession planning, contact Matthew Getzler in our Tax and Wills and Estates Groups at mgetzler@mindengross.com.