

CRACKDOWN ON NRAS' U.S. RENTAL INCOME

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Canadian Tax Highlights
October 2017

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Originally published in Canadian Tax Highlights Volume 25, Number 10, October 2017. Reprinted with permission.

A recent report issued by the Treasury Inspector General for Tax Administration (TIGTA), dated August 23, 2017, says that additional controls are needed to help ensure that non-resident-alien (NRA) individual property owners comply with US tax laws. The IRS has approved several of the report's recommendations for improving the identification of NRAs who are not reporting rental income from US property, and for ensuring that NRAs properly report such income.

An NRA is subject to US income tax on any US-source income, including rental income from US residential real property. An NRA's US taxable income falls into two categories: (1) income effectively connected to a trade or business in the United States and (2) income not so connected.

After allowable deductions, income effectively connected to a trade or business in the United States is taxed at the graduated rates applicable to US citizens and residents; income not so connected is subject to tax at a flat 30 percent rate (on gross rent) that is withheld at source.

An NRA who owns US rental property and is subject to the 30 percent withholding tax on gross rent can elect to treat the income as effectively connected to a US trade or business (Code section 871(d)) and can reduce rental income by related expenses.

According to the report, the IRS does not ensure that an NRA has properly elected before it allows the related tax deductions: TIGTA's random sampling of 149 NRAs who rented out their property in 2013 and filed US tax returns showed that 68 percent of them reduced gross rental

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income when reporting the rental activity but had not complied with the statutory requirement for this tax benefit by submitting a section 871(d) election statement.

The report recommends the revision of form 1040NR ("U.S. Nonresident Alien Income Tax Return") for NRAs for the purposes of the section 871(d) election, and it recommends the revision of the processes and procedures that ensure that the IRS records this election.

The report further recommends that the IRS develop a compliance initiative to address a foreign-property owner who has not reported rental income generated by US real property. The report notes that in a sampling of NRAs who were US-property owners in one of five counties in four US states (Fort Lauderdale, Houston, Las Vegas, Los Angeles, and Orlando), 13 percent of the NRA owners apparently rented out their US property in 2013 but did not file a tax return. The report projects that about 5,634 foreign-property owners may have rented out their US property without complying properly with US filing requirements.

"The IRS should explore the feasibility of obtaining property tax address lists through its information sharing partnerships with the States," the report says. Not surprisingly, the IRS has agreed with this recommendation and has proposed the implementation of corrective actions by October 15, 2018.

Foreign investment in US real property has continued to increase: in 2016, NRAs purchased \$43.5 billion of US real estate. Apparently the IRS now has on its radar the issue of NRAs who either fail to report rental income from US properties or understate their taxable income by not filing properly. Canadians and other NRAs who own US real estate and derive rental income from those properties should ensure that they hire appropriate tax professionals to help them comply with all of the US filing obligations associated with their US real property.