



How U.S. Citizens Living In Canada Can Sell A Principal Residence And Avoid U.S. Capital Gains Tax

As Canadian housing prices continue to set new records, more homeowners are selling their principal residence at huge gains from the original purchase price. That's fine for Canadian tax residents, as the gains will likely be tax-free under the Canadian principal residence exemption. For U.S. citizens living in Canada, to sell a principal residence and avoid U.S. capital gains tax, or significantly reduce it, requires proper cross-border tax planning. There may be a solution to this problem if you are lucky enough to have a Canadian-only spouse to help facilitate a lifetime gifting strategy.



THE ISSUE:

While a Canadian citizen selling their Canadian principal residence is generally not subject to any income tax on the gain, the same is not true if they are also a U.S. citizen (or a U.S. green card holder). Such U.S. citizens may be able to exclude up to US\$250,000 of the capital gain triggered on the sale of a qualifying home, but if the gain is significant, the U.S. tax implications can also be significant.

When a U.S. citizen living in Canada wishes to sell a principal residence, there are many hidden Canadian and U.S. tax issues that can exist. For example, the entitlement to the Canadian principal residence exemption may be at jeopardy if the property has had a change of use (e.g., renting out all or a portion of the property without making the relevant tax elections or making physical changes to the property to accommodate a business). Such hidden tax issues can be mitigated or resolved with proper planning and analysis by a cross-border tax practitioner.

For example, Andrew is a U.S. citizen living in Canada. He is married to Cathy, a Canadian citizen and resident. In 2000, Andrew and Cathy jointly purchased a home in Toronto for CDN\$1M. Today, the current fair market value of their home is CDN\$4M, and they are interested in selling. If the property qualifies as their principal residence, Andrew and Cathy will have no Canadian income tax to pay. However, Andrew, as a U.S. citizen, would be subject to U.S. capital gains taxes for gains attributed to him that exceed the U.S. principal residence exclusion of US\$250,000. Assuming a 1.25 Canadian/U.S. exchange rate and that 50% of the gain is attributed to Andrew (more can be attributed to Andrew depending upon the circumstances), he would be subject to upwards of US\$190,000 in U.S. capital gains tax.

THE SOLUTION:

Common solutions include renouncing U.S. citizenship or dying as the owner of the Canadian principal residence. Both solutions serve to eliminate U.S. capital gains tax. However, the former is not a feasible option for some U.S. citizens due to personal circumstances and/or the U.S. tax cost of renouncing. And the latter is impracticable for a family who wants to sell during their lifetime.

To sell a principal residence and avoid capital gains tax, it may be beneficial for Andrew and Cathy to structure ownership of the Canadian home in the name of the spouse who is not a U.S. citizen. Ideally, this structure would be implemented upon purchasing the home. Since Andrew and Cathy already purchased the property jointly, sole ownership could be transferred to Cathy prior to selling through a lifetime gifting transaction to eliminate the U.S. capital gains tax that would otherwise be payable by Andrew to the IRS.

It's important to note that gifts from U.S. citizen spouses to non-U.S. citizen spouses do not qualify for the unlimited marital deduction that allows tax-free transfers between spouses. Such gifts to a non-U.S. citizen spouse do, however, qualify for a limited annual exclusion (US\$164,000 for gifts in 2022). Any gifting beyond that would have to be covered by the U.S. citizen using some of their lifetime U.S. gift tax exemption, which is the amount that a U.S. citizen can give away during their lifetime (or pass at death) without incurring U.S. gift tax or U.S. estate tax. The exemption amount is indexed for inflation every year (US\$12.06M per individual for 2022). The Biden administration has discussed lowering this amount to as low as US\$3.5M; failing which, the exemption will automatically decrease to an estimated US\$6.2M as of January 1, 2026. Many practitioners advise their clients on the possibility of a "use it or lose it" scenario with respect to lifetime gifting.

After proper planning and implementation of a lifetime gifting transaction, Cathy could sell her 100% interest in the house to a third-party purchaser. Since Andrew no longer owns the house at the time of the sale, there will be no U.S. capital gains tax to pay.

Careful attention must be given to ensure the lifetime gifting strategy is Canadian and U.S. tax compliant and other potential tax issues are properly addressed. Examples of potential issues and special considerations include:

- Whether or not the gift is made "incident to divorce" (in which case the gift may be US taxable);
- The quantum of the gift that must be reported to the IRS on a U.S. gift tax return by the donor spouse, which may require evidence to support the percentage of interest in the property attributed to the gifting spouse;
- Whether local land transfer tax is payable for the real estate transfer;
- Legal documents required to properly formalize the gift;
- Ensuring that a local real estate lawyer properly registers the transfer; and
- Any relevant family law issues that arise in connection with the lifetime gifting strategy.

The lifetime gifting strategy is a specifically crafted, complex solution to limit or eliminate future U.S. capital gains tax liability regarding the sale of a Canadian principal residence, and it's fraught with traps that need to be carefully navigated. Not all solutions are applicable for every individual and unique circumstance, and other complex considerations may arise.

If you are a U.S. citizen living in Canada wishing to sell a principal residence and avoid U.S. capital gains tax, contact **Michael Cirone** to explore all available options. Michael is a Canada/U.S. cross-border tax, trust and estate planning lawyer at TaxChambers LLP, a boutique tax law firm in Toronto.