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WHAT DUAL CITIZENS SHOULD KNOW ABOUT THE US PRINCIPAL RESIDENCE EXEMPTION

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With the ongoing difficulty of trying to apply one country's tax laws to another country, practitioners should note that some of the common tax advice given to clients may not apply when that client is also a dual citizen. An outstanding example of this is the principal residence exemption in Canada.

As we know, under Canadian rules, the principal residence exemption reduces the gain on the sale of an individual's principal residence during the period of ownership for each year during which the property was "ordinarily inhabited" by the taxpayer. Moreover, only a small amount of time needs to be spent in a residence for it to qualify as ordinarily inhabited for that year. It is common practice for Canadian taxpayers to designate an alternative home or cottage that they occupy from time to time – and that has a higher accrued gain than their other home – as their principal residence.

However, the US has significantly different rules and definitions with respect to principal residence, which can result in unexpected US taxes for those taking advantage of the Canadian rules.

The original principal residence rules were based on a deferral of the gains on subsequent house sales until the taxpayer purchases a house of lower value than the one they are selling. Administering these rules involved complex calculations and meticulous recordkeeping for most of one's life. In 1997, the rules changed to review each transaction individually.

The current US rules allow for a maximum exclusion of $500,000 from the gain on a sale to be claimed on jointly filed returns (with a maximum of $250,000 on single, head of household, or married filing separate returns). Fortunately (or unfortunately depending on your perspective), for most taxpayers $500,000 is more than enough to cover the gain on most properties in this current housing market. However, there is tax on any gain above that amount.

The other limitations on this tax exemption are that it can be used only once every two years, and that the home must have qualified as a principal residence for at least two of the five years prior to the sale. There are some exceptions in the Treasury Regulations to Section 121 dealing with the potential for prorating of the two years under certain circumstances, but generally two years of qualification as a principal residence is mandatory.

What can trap our cross-border clients beyond the amount of the exclusion is the US definition of principal residence, which is different from Canada's concept of "ordinarily inhabited".

In *Gates v. Commissioner*, 135 TC No 1 (2010), the court held that the taxpayers were not entitled to the exclusion despite having owned the home since 1984, because they had demolished their house and rebuilt on the same property. The new house did not satisfy the two year principal residence requirement.

The taxpayers had owned and lived in their house since 1984. In 1999, they voluntarily demolished and reconstructed the house to enlarge their living space rather than working within the restrictions of the current home and simply building an expansion. They sold the house in 2000 at a gain of $591,406, and sought to exclude $500,000 under Section 121.

The Court held (albeit with five dissents upon review) that Congress had intended the term “principal residence” to mean the primary dwelling that a taxpayer occupied as his principal residence. In this case they had lived in their prior residence but the new rebuilt residence was not their primary residence and thus not available for the exclusion.

Having multiple residences, which is common for Canadians, may be an issue particularly if one residence is determined to be the principal residence for the exemption in Canada but does not qualify in the U.S.

In *Guinan v. U.S.*, 91 A.F.T.R.2d 2003-2174, the taxpayers owned three residences in different states (Wisconsin, Georgia, and Arizona) and tried to exclude the gain on the sale of the Wisconsin residence (the substantially largest home). The taxpayers participated in recreational and other activities at all three residences, they received mail and had bank accounts at each residence, and they had vehicles at each residence.

The Court considered several factors that contributed to their denial of the exclusion: the taxpayers had filed Georgia/Arizona state tax returns (but not Wisconsin state tax returns); they had registered to vote in Georgia and later in Arizona (but not in Wisconsin); and they had held Georgia and Arizona driver's licenses.

The Court also had Treasury Regulations (Section 1.121-1(b)(2)) available to them that were not in effect at the time of the sale in the Gates case. These regulations provide a number of factors to consider in determining principal residency, including:

- (i) The taxpayer's place of employment;
- (ii) The principal place of abode of the taxpayer's family members;
- (iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- (iv) The taxpayer's mailing address for bills and correspondence;
- (v) The location of the taxpayer's banks; and
- (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated

Clearly, these guidelines are in conflict with any election to have a cottage considered one’s principal residence for Canadian tax purposes.

Ultimately, when working with cross-border issues on sales, it is important to ensure that a sale is not taxable under one country’s regime and excluded in the other, as this could cause a mismatch of foreign tax credits, and a potential for additional tax when the second property is eventually sold.

Other practitioner notes for this edition:

For the past couple of years, the IRS has been working on a program to root out individuals, particularly family members, who transfer property with no consideration and have not filed gift tax returns (Form 709). They found that in their original audit sample, the range of non-compliance was 60-90%; the sample taken in Ohio was found to be 100% non-compliant.

Their initial strategy was to obtain property and state income tax records from 15 states, including CT, FL, HI, NB, NH, NJ, NY, NC, OH, PA, TN, TX, VA, WA and WI.

It is a common Canadian tax strategy to add an individual’s name to titles of property to avoid probate or simply to transfer property among family members. However, with US property – even for non-US citizens or residents – this kind of transfer carries gift tax implications, including the requirement to file a gift tax return. The IRS may be catching up to everyone!

For more information, please contact:

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