

RENTALS, THE NON-RESIDENT ALIEN OWNER, & U.S. TAXES

Non-resident alien (NRA) rental property owners need to be aware of the US tax laws concerning reporting rental activity.

1. *Each* owner is required to file a US income tax return *each* year to report their share of rental income, whether it nets to a profit or a loss. There is no statute of limitation for unfiled tax returns. There are two allowable options to reporting:
 - A. Report only the GROSS rental income and pay a 30% tax on it. No operating expense deductions are allowed. This is very simple, and the default. The IRS can impose it on unfiled, missed, years.
 - B. Elect, by filing for the FIRST year of the rental activity to claim expenses and depreciation against the gross income. Tax is due on only the NET INCOME – at the graduated tax rate. If there is a loss for any year, then that loss, classified as “passive”, is carried forward to another year, to either offset subsequent income, or taxable gain, income, from a sale of the property.

While Option “B”, appears to be a rather easy decision, many NRA landlords seem to ignore U.S. filing until forced to file, usually when they sell or exchange the property.

Worse yet, miss the filing deadline and the IRS is *allowed* to DENY the Option B election to offset income with expenses. See the case at the bottom of this article.

2. For any year with taxable net income, there will be assessment of late-filing and late-paying penalties, and interest, compounded daily. Under Option A, these additions will be substantial.
3. DEPRECIATION IS MANDATORY in the US. Use it or lose it! When the rental property is sold, the "tax basis", (original cost with some additions) of the property will be reduced for the depreciation that should have been taken. There is an allowable "catch-up" but it is complicated. If expenses and depreciation in any year create a loss, then normally the losses, categorized as "passive", can be carried forward to offset future passive income, or the profit on a sale. Normally only buildings and land improvements are depreciable. Note that when sold there will be a recapture ("claw-back") of the depreciation allowed.

The requirement to file has been around for a long time. However since third party (sales escrow) reporting became mandatory a few years ago, the IRS can more easily enforce the law.

A US Tax Court case, *Espinosa v. Commissioner*, 107 T.C. No. 9 (9/24/96) is a good illustration. The NRA owner did not file timely returns as requested by the IRS; subsequently the IRS calculated the taxes based on the gross rents, Option A. The NRA taxpayer later prepared “Option B” tax returns and challenged the IRS on grounds of fairness. He lost, all operating deductions were denied. Therefore gross rent was taxed at 30%, plus penalties and interest. *Espinosa* was simply foolish, however that case gave the IRS a court determination on which to base future actions. It is my experience that you can voluntarily file past returns with little or no problem.

This is simplified and general information presented to alert you to a potential problem. Consult with a competent U.S. tax advisor or tax attorney.

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11/1/07