Are you a US citizen with an Australian Mortgage? Beware of a Potentially Nasty Tax Surprise!

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US citizens residing outside the United States may find that they owe US tax when they've borrowed local currency to finance a primary residence, even if the residence has not appreciated at the point of sale or mortgage refinancing.

Historically, home ownership has been an efficient way to build wealth for individuals all over the world. Rising residential real estate prices, low interest rates, and favorable tax rates or preferences upon the sale of a primary residence combine to make home ownership an attractive investment in Australia, the UK, Canada, and the US. However, for US citizens residing outside the US, purchase of a residence in local currency may later create a nasty US tax surprise if the domestic currency loses value against the US dollar. This results from the fact that, under US tax law, US citizens are obligated (with exceptions not relevant here) to use the US dollar as their "functional currency."

This unpleasant and often unexpected US tax result is triggered when: a) a US citizen borrows to purchase a residence and the loan is denominated in the local currency; and b) the local currency depreciates against the US dollar from the date the debt was incurred until the debt was satisfied. The satisfaction of the underlying debt typically happens upon a refinancing of the debt, or upon sale of the property, which will usually result in an extinguishment of the debt. (The nasty US tax surprise also occurs upon each payment of principal and interest, but I will ignore these payments in order to make my broader point.)

Let's assume a taxpayer who is a US citizen living in Australia and who in 2013 (when 1 Australian dollar equaled 1 US dollar) purchased a house for AUD $500,000 and borrowed AUD $300,000 to do so. Then let's assume the taxpayer sold that house in 2017 (when 1 Australian dollar equaled $0.75 US dollars) for AUD $500,000.

From an Australian tax perspective, the taxpayer has recognized no capital gain on the residence (AUD $500,000 – AUD $500,000 = AUD $0.00). Further, since the individual is a resident of Australia there is no currency gain or loss to recognize.

From a US perspective, however, the result is much different. The individual will realize a capital loss of USD $125,000 [(AUD $500,000 x 1) – (AUD $500,000 x 0.75)] on the disposition of the house. Since the loss was realized by the sale of personal use property, the loss will never be recognized by the US and is lost forever. Further, since the taxpayer is a US citizen, she is obligated to use the US dollar as her functional currency. She will recognize a currency gain of USD $75,000 [AUD $300,000 x 1) – (AUD 300,000 x 0.75)] on the extinguishment of the debt.

This is the nasty US tax surprise that may await all US citizens who borrow non-US currency to purchase personal-use property: in our Australian example, no gain or loss for Australian tax purposes, a disallowed USD $125,000 capital loss on the disposition of the house for US purposes, and a recognized currency gain of USD $75,000 on the extinguishment of the debt on the individual's US tax return.

This is not merely an academic situation of which the IRS is unaware. In Quijano v. United States 93 F.3d 26 (1st Cir. 1996), the US Federal Court ruled against the taxpayer on very similar facts as those set out above. Further, in Revenue Ruling 90-79 the IRS reached a similar conclusion.

In light of the significant US taxable gains that may result when a domestic currency depreciates against the US dollar, all US citizens who have borrowed something other than US dollars to purchase a primary residence need to be aware of these rules.