Investing In Real Estate

Real estate is one of the most popular Canadian investments for non-residents. Real estate investments can provide superior returns and with a strong Canadian economy, appreciation in value ensures security of the investment.

For tax purposes, real property is defined to include land and buildings. The tax treatment of real property varies depending on the nature of the investment. For example, if property was acquired for resale at a profit, it will be treated as inventory of the taxpayer and any gain on sale will be fully taxable. On the other hand, if the property was acquired and used for rental purposes, it will be treated as investment property. Property acquired to be used as part of a business will be treated as a business asset.

Real Estate Development

Taxpayers who are in the business of buying, developing and selling real property usually have the gains from such endeavours taxed as business income. If property is developed as a long-term rental property, a gain on sale may be taxed as a capital gain. Over the years, Canadian tax laws in this area have been uncertain, particularly when it comes time to recognize receipts or deductions in computing the income from such a business.

Sale of Real Property Inventory

When property is sold in the course of a business, the sale price is sometimes receivable over a period of years. In these cases, it is possible to defer the tax on the profit from the sale by claiming a reserve if the proceeds are due after the end of the year the sale is made. The reserve can be claimed for at most 3 years, and is available to non-residents as long as they are carrying on business in Canada. However, if a non-resident sold all inventory during a year and ceased carrying on business, he would be denied a reserve and would have to pay tax on the profit even if all proceeds had not yet been received.

Deductions

The following commentary outlines the Canadian tax treatment of the more common expenses associated with real estate development for both individuals and corporations. In some cases, special rules apply to "principal business corporations". These are

corporations whose business is primarily the leasing, renting, sale or development of their real property, to or for persons with whom they deal at arm's length.

Interest and Property Taxes: Interest and property taxes on vacant land held by a taxpayer primarily for resale or development are only deductible to the extent of any net income from the property. Any amounts not allowed as a deduction are added to the adjusted cost base of the land, thereby reducing business income only when the property is sold. If an amount is deductible, it cannot be capitalized.

Principal business corporations may deduct an additional amount of interest and property taxes up to their "base level deduction", which is calculated by multiplying $1,000,000 times the prescribed interest rate. The prescribed interest rate is a short-term rate on government securities which is announced quarterly and used for various purposes under Canadian tax law.

If two or more corporations are "associated" (that is, under common control and ownership), they must agree to share the benefits of the base level deduction.

Soft Costs: "Soft costs" include certain promotion expenses, legal and accounting fees, and mortgage fees, as well as interest expense and property taxes incurred during the period of construction of a building. Generally, these costs must be allocated to the cost of the building. If the property is held for resale, these costs will be recognized when the property is sold. If the property is held to earn rental income as a long term investment, the cost is amortized over a period of time through capital cost allowance claims. Deductions for soft costs on rental buildings under construction are allowed to the extent of any rental income earned on the building.

Servicing Costs: These include outlays such as the costs of roads, sewers, water-mains, street lighting, sidewalks, hydro installation charges, and the cost of recreation facilities. They also include development costs such as various legal, planning, engineering, mortgage and survey fees. In general terms, all such amounts are usually treated as part of the cost of inventory.

Expenses of Representation: Amounts paid by a taxpayer in the year for expenses incurred in making any representation to a government may be deducted by the taxpayer in computing income from a business.

Rental Properties

For tax purposes, rental properties include any real estate acquired for the purpose of earning income from renting or leasing the property. They range from residential accommodation such as houses and apartment buildings, to commercial real estate such as shopping plazas, factories and office buildings.

Rental Income

The tax consequences of earning rental income in Canada will vary, depending on whether the taxpayer is a German individual, or a Canadian or German corporation. The nature of the operation will determine whether the income is considered to be income from property or income from business. This distinction is important since property income and business income earned by non-residents are subject to different rules.

Property Held By A Corporation: There is a general presumption under Canadian law that a corporation engaged in the activities for which it was formed is carrying on business. Therefore, rental income is often treated as business income for corporations. However, the final determination would depend on the facts and circumstances of each case, and would hinge on the level of involvement and management required by the German directors/shareholders, and the extent and diversity of other operations and activities of the corporation. In some cases, rental income earned by a CCPC is deemed to be property income to prevent such corporations from claiming the special low tax rates on business income up to certain specified income thresholds. However, these rules would generally not apply to a private corporation owned or controlled by German investors.

Rental income earned through a Canadian corporation controlled by German investors would generally be taxed as business income or in a manner similar to business income, as described earlier.

If the rental income earned by a German corporation is income from carrying on a business, the rental property would be a Canadian permanent establishment and the corporation would be taxed on the income attributable to it. There would be no withholding tax on gross (or net) rents provided that the payor receives authorization from the Canada Customs and Revenue Agency to do so (this would normally have to be arranged by the corporation). However, the corporation would be liable for monthly federal and provincial income tax instalments (based on prior year's taxes), and subject to 15% branch tax on repatriated profits in excess of $500,000.

Taking the position that rental income is business income is advantageous where significant rental expenses are incurred. If net income is low, the corporate tax instalments required would be minimal. Business income treatment is also preferable if losses are incurred as business losses can be carried over to other years while property income losses cannot.

Alternatively, if the rental income of a German corporation is treated as property income, the gross rents would be subject to 25% withholding at source.

A German corporation, along with an agent resident in Canada, can elect annually to have the withholding made on the net rental income (before depreciation), provided a tax return is filed within 6 months after the particular taxation year under election. Under such an election, the effective tax position of the corporation becomes the same as if the rental income had been treated as business income, except for a potentially different pattern of monthly tax payments (that is withholdings, instead of instalments) and the fact that rental losses cannot be carried forward or back to offset rental income of other taxation years.

Taking the position that the rental income is property income is generally preferable where the corporation has relatively small rental expenses since a 25% tax on gross income may be less than normal corporate rates (37% to 45% depending on the province) on net income. In this case, the corporation would not elect to have withholding tax apply on net income.

Property Held By An Individual: A German individual owning rental property in Canada will be subject to 25% withholding tax on the gross rents. There is no rate reduction under the Canada-Germany Tax Treaty. However, as for German corporations, the individual, along with a rental agent resident in Canada, may elect each year to file a tax return in Canada within 6 months and pay Canadian tax on the net rental income, after claiming expenses and tax depreciation. In the event such an election is made each year, the agent who receives rent on behalf of the non-resident is obliged to withhold tax only on the net rental income (before depreciation).

If no election is made, the non-resident individual may still file a Canadian tax return within two years after the particular year and pay tax on the net income. This latter situation will require the agent to withhold on the gross rent rather than the net rent.

Upon filing of a Canadian tax return, the withholding tax withheld during the year is treated as an instalment and any excess is refunded.

As a rule of thumb, the undertaking to file a Canadian tax return would not be made if the withholding tax was less than the applicable Canadian tax. On the other hand, if the net income was nil or low, it would be worthwhile to make such an undertaking.

In either case where the individual elects to use the net basis, he will be required to file a return and pay tax on any recapture of depreciation previously claimed and any capital gain in the year the property is sold (see below).

Expenses

Purchase: When you purchase a rental property, you must allocate the purchase price between the land and building. This is important since the cost allocated to the building may be deducted from rental income over time as CCA while the portion allocated to land cannot be deducted. Special rules allow the tax authorities to adjust unreasonable allocations.

Capital Cost Allowance: The portion of the purchase price allocated to the building, or the cost of constructing the building is deducted under the capital cost allowance rules discussed previously.

Generally speaking, rental buildings are written off at a maximum rate of 4% per year (5% for buildings acquired prior to 1988) on a diminishing balance basis. Only one-half the normal rate (2%) is available in the year of acquisition.

In addition to the building, rental properties may contain other assets such as stoves, refrigerators, dehumidifiers and other appliances and furnishings. These can usually be written off at a maximum rate of 20% per year on a diminishing balance basis (10% in the year of acquisition). Parking lots can be written off at a rate of 8% (4% in the year of acquisition).

Subsequent to 1971, several measures were introduced to restrict the use of rental properties as tax shelters. The major restriction prevents taxpayers from claiming CCA to either create or increase a rental loss. (This does not apply to principal business corporations.) Also, each rental property costing more than $50,000 must be placed in a separate CCA class, thus preventing the deferral of recapture on sale by replacing the property.

Interest and Property Tax: Interest and property taxes may be deducted when incurred against rental income. On the other hand, a taxpayer may under certain conditions elect to capitalize the interest incurred on the depreciable property rather than deduct it. The interest then forms part of the capital cost which is written-off at the CCA rate for the depreciable property. This should be considered in situations where losses have or will be realized and possibly not claimed before they expire. Business losses can be carried forward seven years and carried back 3 years. In the case of losses where the rental income is income from property, no carryover is allowed for non-residents.

Other Expenses: Other outlays which are made to earn income from the rental property may be deducted in arriving at net rental income. These include salaries, maintenance, telephone, bookkeeping, and others. Major expenditures which give the property an enduring life will be capitalized and written-off over a number of years.

Landscaping is generally fully deductible in the year incurred. Amounts incurred to investigate the suitability of a site for a rental property or to make a utilities service connection to a rental property may also be deductible provided the rental activity is considered to be a business.

Disposition of Rental Property

The disposition of a rental property may give rise to tax in two ways. First, the sale proceeds (up to the original cost of the asset) must be deducted from the CCA pool, and a negative balance results in recapture of CCA. Secondly, the amount by which the proceeds exceed the original cost and selling expenses represents a capital gain, of which 50% is taxable. It is not possible to incur a capital loss on depreciable property.

Recaptured Depreciation: An investor who acquires a rental property will usually claim the maximum CCA permitted. To the extent the property does not come down in value, the depreciation previously claimed will be recaptured and be subject to tax, unless there are other assets in the same asset pool or, in certain situations, another asset is acquired to shelter the taxation.

Recapture is treated as rental income. In most cases, it is taxed in the year it arises regardless of when the proceeds of disposition are received. However, taxation may be deferred if the disposition was due to expropriation, theft, or destruction and the asset is replaced within two years from the year of disposition.

Capital Gains: As noted previously, the sale of a capital asset receives favourable tax treatment: only 50% of the amount is subject to taxation. Whether or not a particular asset is considered to be capital in nature depends on a number of facts and circumstances. The following criteria are some of those used to determine whether the sale of rental property or any investment in real property, is a capital or income transaction.

1) Intention of Vendor at Time of Acquisition: Where a property is acquired with the intention of later selling it for a profit, the gain will be treated as regular income. The fact that the owner leased or rented it out during the period of ownership would not change the treatment.

2) Relation of Transaction to Taxpayer's Business or Occupation: The fact that the vendor's regular business or employment involves dealing in real estate may indicate that the transaction was of an income nature, and not a capital property.

3) Number and Frequency of Transactions: If the vendor has a number of sales of similar assets, the gains from dispositions of such property are more likely to be treated as regular income.

4) Length of Time Property Held: If the vendor holds the property for a short period of time, any gain realized on its sale will likely be treated as regular income.

Note that these rules generally apply to sales of other non-real estate assets as well.

It is possible to claim a reserve to defer the taxation of a capital gain for up to five years where the proceeds of disposition are not due until a subsequent taxation year. However, this reserve is not available to a taxpayer who is non-resident either at the end of the taxation year or at any time in the immediately following year.

In the case of a private corporation, the untaxed 50% of the capital gain may be paid out tax-free as a capital dividend. Capital dividends paid to non-residents are subject to the same withholding tax treatment as regular taxable dividends.

Filing Requirements

The Canada Customs and Revenue Agency must be notified prior to the disposition of a rental property (or any Taxable Canadian Property) by a non-resident. The vendor must remit the estimated Canadian tax on the disposition: 33 1/3% of the capital gain plus the estimated tax on any recapture. He will receive a certificate proving these requirements have been met.

The purchaser is required to withhold 33 1/3% of any proceeds not covered by a certificate. Failure to take these steps could result in the purchaser being held liable for the non-resident's Canadian tax.