LATHEM'S LEGALS

Real Estate Law Series of Newsletters **June 2013**

REAL ESTATE AND TAXATION ... UNDERSTANDING THE BIG PICTURE

How Canadians Are Impacted by Real Estate and Taxation

In my practice I spend a lot of time highlighting with clients tax issues with Real Estate and drawing their attention to potential problems. Investing in Real Estate always has tax implications and they come in at least 6 typical areas, they are:

- Capital Gains
- Income
- HST/GST
- Land Transfer Tax
- s. 116 - Non-residency Taxation
- Multi-Resident Taxation

The Role of Intent

Key in how all the tax authorities assess a particular position taken by a tax payer in the Income Tax, HST/GST returns and Land Transfer Tax is what purpose the client intended to acquire a property for. When making this assessment the various Government Agencies involved look to outside indicators of intent in deciding whether to accept the owner's position or to reassess the client's position.

Understanding the Big Picture....Government of Canada Policy on Real Estate "Investing"

Key to understanding taxation and Real Estate is understanding that when it comes to taxation there are financial objectives at play and they aren't simply raising Revenue for the Government. Understanding these issues is key not only to understanding the existing tax and mortgage regime, but also where it is likely to go in the future.

I think the Government Objective was best set out by a Senior Employee of the Bank of Canada and close friend to Mark Carney, who spoke to our local Rotary Club. He said the Government of Canada's objective was that Canadians be able to afford houses. This means that the primary objective of the Canadian Government is that most Canadians be able to afford and pay for their home. The specific implications are:

1. Houses must be affordable in price;
2. The prices must be stable (not decrease); and
3. They must not become the primary investment vehicle or engine for the economy.

This translates into a few things:

1. House prices must stay low or affordable;
2. They must not decrease and in fact there must be an incentive to invest in Real Estate without at the same time pushing them into the unaffordable category; and
3. That the Government is not interested in Policies that encourage Real Estate as being the primary creator of wealth and jobs...in other words it's perceived to be a more non-productive wealth creator.

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There is an additional aspect to Government of Canada Policy, that is policies that encourage the production of a rental housing stock for those who are not able to purchase their own home.

Capital Gains

When property is bought and sold they are taxes on 1 of 3 basis:
- principal residence;
- capital gains; or
- inventory.

There are basically 3 policy objectives at work.

Principal Residence Exemption

Each Family is exempt from Capital Gains, which means any money they have made through increase in value of the Principal Residence. The Policy purpose here is to encourage and allow Canadians to purchase their family home. This means there are some restrictions:
- each family unit is only entitled to one family home
- the primary intent must be as a family residence
- secondary residences and cottages are not granted such exemptions

I think its is important for me to discuss a common misconception about the principal residence exemption. I have often heard clients claim that they were told that the use of the property at the time of sale was relevant to the principal residence exemption. The logic being that if one owned a rental property for 10 years, by simply moving into it 1 year before you intended to dispose of the property you could shelter all the Capital Gains exemptions that occurred over the previous 10 years. Not so, you cannot claim the principal residence exemption for the period of time you did not reside in the property.

Realistically if one owned 2 properties, such as a cottage it is a matter of deciding which property is likely to see the greatest capital gains increase and designate this property as the principal residence.

Inventory Verus Capital (Income Versus Capital)

Where the principal residence exemption does not apply there is another tax break in investment real estate that often applies called Capital Gains. For those who are not familiar with Capital Gains its a tax treatment of the sale of property that is treated as the sale of a Capital Asset versus Inventory. The tax result is that only 50% of the profit made on the sale is added to the income meaning that the maximum possible tax on the increase in value is 25%, versus income which would as high as 50%.

If one looks at Tax Policy and Rules, essentially when one invests in Real Estate for the purpose of producing some form of income but not primarily from the increase in the value of the Real Estate itself, the increase in value is treated as a Capital Gain. Capital by definition is an investment intended to produce income. In the case of stocks, Capital is the amount invested in the stock, whereas the income is the dividend. Where the income is simply based on an increase in value of the assets itself (land) and that was the intent of the investor then the increase in value is characterized as straight income.

To illustrate this distinction we can use as an example the owner of a convenience store who purchases both a building in which he uses for his store and also purchases candy bars to sell. The purchase of the building is viewed as the purchase of Capital as it is being as a necessary facility another activity which

is intended to generate profit, whereas the purchase of candy bars are simply for resale. So the purchase of Real Estate is seen as being made for the purpose of facilitating (in support of) the primary business activity and is not the primary business activity, then it is a Capital Gain.

So when one purchases Real Estate in order to locate a business or generate rental income the investment of the Real Estate is treated as Capital and upon its disposition only 50% of the gain is added into income resulting in a maximum 25% tax rate.

This is contrasted with the flipping of Real Estate where it can be assessed by Revenue Canada as sale of inventory and taxed at 50%.

While the above sounds academic, CRA has actively gone after 3 types of Tax Payers for improperly characterized their transactions as Capital Gains versus Inventory, all of them are typically Real Estate Investors:

1. Builders who purchase lot, homes to tear down or renovate;
2. Real Estate Agents who typically invest in and turn over properties or other investors who usually buy and sell properties; and
3. People who purchase properties, particularly new Condos on the basis that they will flip the properties before closing.

In the above cases CRA does look for a clear pattern on the part of the taxpayer. They are usually looking for 3 transactions within a short period of time. One year is the rule of thumb. If they find that a purchaser who purchased 3 condominiums and has assigned or sold them all prior to closing or within 1 year of occupancy they will characterize the transaction as inventory and tax the whole profit as gain. On houses, they typically look for a purchaser who has purchased 1 house per year and usually hit the taxpayer with the assessment on the 3rd disposition.

Understanding Capital Gains..and the “house hoppers”.

The house hopper is a term used by CRA to describe the builder who typically buys a lot or tear down, then builds a new home lives in it for a period, usually 1 year, then resells trying to claim exemption from TARION, HST and Income Tax under the Principal Residence Exemption. CRA typically makes its reassessment on the 3rd transaction and then characterizes the series of transactions as inventory. The reality is that most builders faced with this reassessment end up bankrupt.

This used to be the old 1 year rule x 3, as I have discussed above, but CRA has recently become more sophisticated. It is clear that many Canadians move frequently and use their house as an investment vehicle. So what CRA has done is looked for people who simply move more frequently then the norm. So the same builder who builds his or her own home and moves no more frequently then is typical in the local market is probably going to be safe taking the filing position that the property is a residence.

HST/GST

Except used residences all Real Estate is subject to HST. Here is how it breaks down:

1. Since HST allows for input credits straight Commercial Real Estate has a rollover where the buyer never pays the HST, because it would have to be paid back in short order by the Government (the buyer must be registered for HST for this to apply).

2. So New Residential Real Estate is for the most part the only Real Estate where HST is actually paid.

Again, this is where Government Policy comes into play. The Government wants to encourage 2 things:
1. The acquisition of Real Estate as Family Residences; and
2. The acquisition of Rental Housing.

The HST legislation is primarily geared to Family Residences. However, for both Family Residences and Rental Housing the HST payable is at a reduced rate. So most new Residential Real Estate is advertised at with Hst included at the reduced rate. The difference between Family Residences and Rental Housing is as follows:
1. On closing the builder is obliged to collect the price as set out in the Agreement of Purchase and Sale and obtain from the purchaser documents proving it is being purchased as their family residence to establish to the Government why it has not collected the full HST owing (13%); and
2. With rental housing the building must collect the full 13% and the purchaser then must apply within 2 years of the occupancy date (for Condominiums) or closing date (for houses) by proving that they purchased the property having entered into a 1 year lease with a tenant.

If the property was purchased for purely speculative purposes, i.e. flipping then the full HST would be payable without any entitlement to rebate. However, it should be noted that in the absence of an HST rebate the additional HST presumably would be a deduction upon sale because the acquisition costs of the property would be higher.

With respect to both the rental properties and those that were purchased for speculative purposes the average increase in purchase price over that set out in the agreement is 8% if the properties purchase price is under $450,000.00. If more then $450,000.00, it is a flat $24,000.00.

Land Transfer Tax

Land Transfer Tax can be best described as a sales tax on land. It is payable at any time that there is a beneficial change in ownership. The terms Beneficial essentially means Real Owner versus Titled Owner.

Again consistent with Government Policy there is a tax break designed to encourage or facilitate families acquiring a residence, that is the first time buyers exemption which exempts a first time buyer from Land Transfer Tax up to $2,000.00 from Provincial Land Transfer Tax and $3,700.00 against the tax payable if one is buying in the City of Toronto.

The restrictions are:
1. That the person must never have owned Real Estate before anywhere in the world (i.e. not just Ontario or Canada); and
2. The person's spouse must also have not owned property in Ontario while they were married.

This specific exemption is audited by the Province of Ontario by running the names through the land records ... so virtually no one gets away claiming this exemption improperly without getting caught and having to pay taxes and penalties.

Intent...Big Brother and the Information Age

If you deal with, consult and review the tax rulings regularly as I do, you realize that the authorities determine a taxpayers entitlement to a preferential tax treatment on the basis of what the intent of the taxpayer is. The authorities, and ultimately the courts, look to external indicies of intent such as what the taxpayer has filed in their income tax, hst returns and what the land records including land transfer tax affidavits to see if the taxpayer seems to be telling the truth.

I give a lot of tax advice when it comes to investment properties. There are 2 pieces of advice I often find myself giving clients:

1. You cant suck and blow at the same time (i.e. you are stuck with what you have put in writing, think about it); and
2. Are you asking me a legal question or are you asking me if you are going to get caught.

When I started practising Law some 20 years ago, all the records were paper and prohibitively expensive for anyone including the Government to piece together. About 2000 all of the land records started to become computerized and about 2006 90% of the land records were computerized and made almost immediately available to all lawyers, real estate agents and the Government. So now within virtually 10 minutes anyone at CRA and the Ministry of Finance checking out an income tax filing, hst return Land Transfer Tax Affidavit can call up a taxpayer records comparing their residence as claimed over the last 6 years, against the land records showing all the properties they have owned and the HST exemptions claimed.

I have been told by a number of builder lawyers I deal with regularly that on virtually every hst exemption CRA looks at the income tax return of the person filing the exemption and their income tax. For example the taxpayer is claiming an exemption for a 1 bedroom apartment, yet they appear to be married living in a 4 bedroom family home with children, according to their income tax. Then CRA takes the position that it is not likely they are moving into the property as a residence.

I have regularly consulted with CRA on behalf of clients. I can recall one of the first GST cases I had to deal with. The scenario was that the clients had purchased a property on Bayview Avenue in Aurora where there was no public transit. The husband had become disabled and unable to drive. As a result they needed to acquire a property on Yonge Street where they had access to public transit and wanted to resell the home following closing. As a result I telephoned CRA to discuss the GST exemption. The advise was that GST exemptions are based on intent as is other exemptions. CRA at that time did not randomly audit for principal residence exemptions, GST etc.., those transactions that occurred over 1 year, rather they picked or red flagged those transactions that occurred less then 1 year. I was advised that this client was entitled to the exemption, it should be claimed, but they should be prepared to substantiate their claim to the exemption to CRA because it was likely they would ask.

s. 116 - Non-residency Taxation

When non-residence sell Property in Canada they are required to pay 25% tax of the Capital Gain or increase in value. By the legislation they are required to pay 25% of sale price to Revenue Canada pending the ruling. If the filing is received prior to the closing the ruling are often received within a couple of months of the rules. If the filing is received following the rules, the ruling and release of funds can be up to 1 year following the closing. In the process of processing this application CRA will require

that if this is an income property or the non-resident had Canadian Income that those returns have been filed and assessed.

In addition, one needs to pay attention to the encumbrances on the property and how quickly the sellers needs to have access to the sale proceeds. The seller must be in a position to have the 25% held for up to the one year required to complete the assessment.

A word of caution, care must be take that a Canadian resident who acquired a property as a Canadian including a Canadian Residence who leaves the Country can be considered a non-resident and this problem can arise.

Multi-Resident Taxation

The majority of the clients in my practice are residents of multi-jurisdictions, or have property in multiple jurisdictions. This has very major implications under both the tax legislation and incidentally the family law legislation here in Canada. I don't propose to deal with the latter here.

Some Countries like the US base their tax system on residency and some countries base their tax system based on residency like Canada. Both tax systems will tax income earned within the Jurisdiction. The difference is that if you claim US Citizenship no matter where you live in the world the US government will assess your income tax based on your holding throughout the world. In Canada where your tax is based on Citizenship Canadian Government will claim taxes based only where you live. So if you are a Canadian and Russian Citizen living in Moscow they will only claim income on what you earn in Canada, however, if you live in Canada they will claim income tax owing under Canadian Tax rules based on your income and assets in both Countries.

It has been obvious in my dealing with most of my clients who are now Canadian Residents and Citizens that they fail to understand that both in Family Law and in Tax Law they are accountable vis a vis the amount of tax they owe for the property they owe worldwide. It is also a major issue for those who become Canadian Residents and Citizens and then exit the Country owing exit taxes.

CONCLUSIONS

When it comes to making a Real Estate Investment decision you can really only take into account your profit after you take into account a few things:

1. Increase in Value
2. (Less) Inflaction
3. Less Commission
4. Less Mortgage Penalties
5. **Tax**

So Tax is an important part of this equation.

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My final word of advice for anyone using Real Estate as an Investment vehicle is to use a lawyer who has a working knowledge of the issues and is familiar with your business and use a properly qualified tax professional for tax advice and preparation of your taxes. This means using a “CA” or Chartered Accountant.

We hope that you find this issue of our newsletter interesting and we look forward to suggestions regarding what other issues you may want covered in upcoming newsletters.

Yours sincerely,

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