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Tax Considerations for Non-Resident Individuals Investing in Canadian Rental Real Estate (rented monthly)

Sept 20, 2010

Taxation upon acquisition (Property Transfer Tax) and annual property tax

- 1) Property Transfer Tax is payable at the time of purchase of real property. This tax is calculated at 1% on the first \$200,000 and 2% on the excess over \$200,000. Other acquisition costs may include inspection fees, appraisals and legal fees.
- 2) Municipal property taxes are due annually and a pro-rata portion will be payable based upon the number of days that the property is owned in the year of acquisition. Thereafter, property taxes must be paid each year (e.g. Feb. 2 and July 2 for Vancouver) and arrangements should be made with the municipality to ensure they are paid on a timely basis. The amount is based upon the assessed value and the “mill rate” set by the municipality. As a general “rule of thumb”, annual property taxes are approximately 0.4 to 1% of the value of the property.
- 3) The Harmonized Sales Tax (“HST”) of 12% will be charged on chattels (furniture and fixtures) which are separately identified in the purchase agreement. British Columbia Social Service Tax (commonly called Provincial Sales Tax or “PST”) was replaced by HST as of July 1, 2010. The HST of 12% will generally be charged on the purchase of a newly built property. This HST will become part of the cost. However, a portion of the HST paid may be able to be claimed, under certain circumstances, in accordance with the New Residential Rental Property Rebate for a property which is rented on a long-term basis. No HST will be charged on the sale of a used residential property, which includes most homes, townhouses or condos which are rented on a monthly basis. The purchaser cannot and should not register for HST.
- 4) The HST will not be applicable to the purchase of a used residential home no matter how it will be used.

Taxation of Rental Income

- 1) **Gross rental revenue** is subject to a **withholding tax of 25%**. The tenant or Canadian agent, if one exists, must withhold this tax and remit it to CRA (“Canada Revenue Agency”) monthly. If the non-resident takes no further action (i.e. see “*option 1*” in the attached schedule, “*Example Calculations of Three Options*”), this will be the final tax. The penalty for not withholding is 10% of the amount that should have been withheld. In addition, interest will be charged at CRA’s “prescribed rate” (currently 5%). If no withholding tax has ever been remitted and if the two year period explained in 2) below has passed, the agent (or the tenant if there is no agent) will be required to pay a **penalty of 25% of gross rental revenues** plus interest. CRA will assess the agent (or the tenant if there is no agent), but if the property is still owned, the non-resident will be ultimately responsible.
- 2) The non-resident has a **second option after** the end of the taxation year. They may calculate taxable income based on **net rental income** (after deducting related expenses such as interest, property taxes, management fees, maintenance, repairs, strata fees, insurance, accounting fees, etc.) and elect to file a **T1 personal tax return**. The taxable income will be subject to **progressive tax rates ranging from approximately 22% to 43%** for 2010. If the income tax calculated in this manner is less than the tax originally withheld, the non-

resident will receive a refund for the difference. This tax return **may be filed any time up to two years after the end of the applicable taxation year** (e.g. for the 2010 taxation year, it may be filed up to December 31, 2012). This option is normally beneficial and will result in a refund as rental expenses will usually cause income taxes to be less than the taxes withheld (25% of gross revenue).

- 3) In the calculation of taxable income, depreciation (referred to as “Capital Cost Allowance” or “CCA”) may also be taken to reduce taxable income. The CCA rate on buildings is 4%. However, an individual who is contemplating moving into the property in the future (e.g. retire to Canada) should normally not take any CCA during the period that he is renting it. This is to avoid deemed disposition rules which result from a change of use. If the property is sold for a gain, previously deducted CCA will be brought back into income at the time of sale.
- 4) A *third option* is available **before** the commencement of a taxation year. If the non-resident has a Canadian "agent" for income tax purposes (the tenant or management company may become the agent), the non-resident and the agent may elect to file a T1 tax return by filing form **NR6 before the beginning of the taxation year**.
- 5) In the NR6 form, the non-resident and property manager will estimate net income for the year and are only required to **withhold 25% of estimated net income**. The non-resident must then file a T1 by June 30 of the year following the taxation year. If the T1 is not filed by June 30, a **penalty of 25% of gross rental revenue** will be assessed against the agent. This third option is usually beneficial from a cash flow point of view if there are any rental expenses. The total taxes will be the same as those in the second option mentioned above, but the non-resident does not have to wait for a refund. Again, any difference between actual taxes calculated on the T1 and taxes withheld during the year will be payable or refundable.
- 6) For non-residents, rental losses **cannot** be carried back or forward to other taxation years.
- 7) A form **NR4** must be filed by the Canadian agent (or tenant) for each taxation year by March 31 of the following year to report total rental revenue and the amount of taxes withheld. In order for the agent to remit taxes and prepare this form, they must apply to CRA for a “non-resident remittance number”.
- 8) Tax planning issues which should be discussed include ownership structure, capitalization of expenditures to reduce tax or future gains, potential capitalization of interest expense, risks of borrowing outside Canada, treatment of income as business income and other similar issues.
- 9) This pamphlet only addresses the tax implications of monthly rentals. If the property is rented on a nightly basis, there are implications for both income tax and HST on the purchase, rental and sale of the property. Please contact us if you feel this may be of relevance to you.
- 10) Some rental properties, which are operated as a hotel, may qualify for treatment as “business income” as opposed to “rental income”. This will be determined by the management company as they must apply to CRA for authorization for income to be treated as business income. The tax treatment of business income is different than rental income and there are several advantages for non-residents to have the income treated as business income. Please contact us if you feel this may be of relevance to you.
- 11) HST should not be charged on monthly rentals.

Taxation on disposition

- 1) Any gain on the disposition of rental property in Canada will be subject to tax in Canada. This tax is levied in two stages. First, there is a withholding tax at the time of disposition and then a final calculation of tax as reported in the T1 personal tax return which is due after year end.
- 2) The withholding tax is paid by filing a form **T2062** and paying a **withholding tax of 25% of the interim gain on sale**, plus up to 44% of recaptured CCA, if any. The interim gain is calculated as the selling price less the

cost for tax purposes. At this stage, commissions, legal fees and accounting fees are not deductible in the calculation of the interim gain. Once this form is accepted by CRA and the tax has been paid, CRA will issue a **“Certificate of Compliance”** (see attached “Example of Canadian Taxation upon Disposition of Canadian Real Estate by Non-resident Individual”).

CRA is concerned that the non-resident may sell the property, take the proceeds out of Canada and never pay any tax. It would be very difficult for CRA to collect tax from a non-resident who no longer has any assets in Canada. Therefore, the way that CRA enforces the collection of this tax is to transfer the obligation to pay tax from the non-resident vendor to the purchaser of the property. Unless the purchaser receives a signed declaration that the vendor is a resident of Canada or receives the above-mentioned Certificate of Compliance, the purchaser will be liable for withholding tax of **25% of the selling price** (on the portion relating to land) and potentially 50% of the portion of the selling price relating to the building (although this is not often demanded by the purchaser’s lawyer) and the purchaser’s lawyer must remit this withholding tax to CRA. (Technically, if CCA has been claimed and CCA is “recaptured” upon disposition, the withholding tax on the portion of the gain relating to the building may be increased to 50%. However, the purchaser’s lawyer may demand 50% withholding tax on the entire proceeds.) Therefore all knowledgeable purchasers will request a Certificate of Compliance when purchasing property from a non-resident. This procedure applies whether the purchaser is a Canadian resident or not.

In practice, the purchaser's lawyer will generally hold back 25 % of the entire purchase price until they receive the Certificate of Compliance. Technically, this tax must be remitted to CRA by the end of the month following the month of closing. However, this requirement can be waived by obtaining a “Comfort Letter” from CRA. It currently takes about 12 to 16 weeks for CRA to process a Certificate of Compliance. The form T2062 may be filed before, and must be filed within 10 days of, closing and we suggest that it be filed as early as possible. Penalties will be assessed if it is filed later than 10 days after closing.

In the Certificate application form T2062, CRA requests information regarding the rental of the property during the period of ownership. If the property has been rented but withholding taxes have not been paid, CRA will require that all the previous tax returns be filed and all outstanding taxes, interest and penalties also be paid before they will issue the Certificate of Compliance.

- 3) **After** the end of the taxation year in which the property is sold, the non-resident may file a T1 personal tax return to report the disposition of the property and calculate the actual gain and the final tax. In this calculation of the actual gain, they can deduct all related selling expenses such as commissions and legal and accounting fees. In addition, depending on the circumstances, they may be allowed **“capital gains treatment”** which means that only 1/2 of the gain will be taxable. The taxable income will be subject to progressive rates from **22% to 43%** (for 2010) and if the total tax is less than the withholding tax paid at the time of obtaining the Certificate of Compliance, the non-resident will be entitled to a refund of the difference. Please refer to the attached “Example of Canadian Taxation upon Disposition of Canadian Real Estate by Non-resident Individual”.
- 4) There is no tax deferral available if a replacement property is purchased (e.g. similar to a US tax “Section 1031 tax deferred exchange”). Such deferral is only available for a “business” property, under certain conditions.
- 5) HST should not be charged on the sale of a used residential property which was rented on a monthly basis.

Change of use

There are special very complex rules for the full or partial change of use of the property.

For income tax purposes, there will be a deemed disposition, and re-acquisition, at the fair market value if the property is changed from revenue producing (nightly or monthly rentals) to not producing revenue, or from not producing revenue to revenue producing. This could result in income taxes being payable on any increase in value, even though the property has not been sold. It may be possible to avoid the deemed disposition by doing a special election.

There may be additional complications for a mixed-use property (e.g. part-year nightly rentals, part-year monthly rentals and personal use). Complications could also result, for example, from renting a suite in the home.

Professional advice should be obtained for any proposed change of use.

This memo is of a general nature only and professional advice should be sought before completing any transaction.

We can help you

We can assist the non-resident and the Canadian agent or tenant as noted in our pamphlet entitled “Services for Non-resident Individuals Investing in Canadian Real Estate”. In order to provide you with the services noted above, we ask that you complete our Questionnaire.

Please contact us if you would like either of the above.

Please note that we also have additional pamphlets regarding nightly rental producing rental income, nightly rental producing business income and ownership without rent.

Contact

For further details or questions, please contact Don Nishio (in English or Japanese), Mike Lam (Cantonese or Mandarin), Bernard Lo (Cantonese).

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**Tax Considerations for Non-Resident Individuals Investing
in Canadian Rental Real Estate (rented monthly)
Example Calculations of the Three Options**

Sept 20, 2010

Examples:	OPTIONS		
	1	2	3
		File T1	File NR6 & T1
Rental Revenue	\$ 15,000	\$ 15,000	\$ 15,000
Expenses			
Advertising	100	100	100
Insurance	300	300	300
Interest	7,000	7,000	7,000
Management Fee	1,200	1,200	1,200
Property Tax	1,800	1,800	1,800
Repairs and Maintenance	3,000	3,000	3,000
Professional Fees	100	400	700
Utilities	500	500	500
	<u>14,000</u>	<u>14,300</u>	<u>14,600</u>
Net Income before Capital	1,000	700	400 *Note 1
Capital Cost Allowance (optional)	<u>0</u>	<u>(700)</u>	<u>(400)</u>
Net Income	<u>1,000</u>	<u>0</u>	<u>0</u>
Income Tax (eg. Net Income x 25%)	<u>0</u>	<u>0</u>	<u>0</u>
Tax withheld (\$15,000 x 25%)	<u>\$ 3,750</u>	\$ 3,750	\$ 100 *Note 2
Final Income Tax	<u>\$ 3,750</u>	<u>\$ -</u>	<u>\$ -</u>
Income Tax (Refund)	<u>0</u>	<u>(3,750)</u>	<u>(100)</u>
Net cash inflow after tax (refund)	<u>\$ (2,750)</u>	<u>\$ 700</u>	<u>\$ 400</u>

Notes:

- 1) Please refer to our pamphlet "Tax Considerations for Non-Resident Individuals Investing in Canadian Rental Real Estate" for an explanation of the above example calculations
- 2) Withholding tax per NR6 equals Net Income before CCA times 25%.

**Example of Canadian Taxation
upon Disposition of Canadian Real Estate by Non-resident Individual**

Sept 20, 2010

Assumptions:

Purchase (Note 1)		
Purchase price	\$	393,000
Property transfer tax		6,000
Legal fees on purchase		1,000
Tax Cost ("Adjusted cost base" - "ACB")		400,000
Sale (Note 1)		
Selling price		600,000
Commission for selling		22,000
Legal and accounting fees for selling		4,000
Mortgage loan balance at time of sale		200,000

Withholding tax at time of disposition to obtain Certificate of Compliance ("CC")

Selling price	\$	600,000
less: ACB		(400,000)
Interim capital gain		200,000
Withholding tax rate		25%
Withholding tax payable (Note 2)		50,000

Cash flow on sale

Selling price	600,000
less: Commission	22,000
Legal and accounting fee	4,000
Mortgage payout	200,000
Holdback by lawyer at 25% on 600,000	150,000
	(376,000)
Net payment to non-resident ("NR") owner on closing	224,000
Holdback by lawyer	150,000
less: Withholding tax paid for CC (see above)	(50,000)
Net payment to NR owner upon receipt of CC	100,000

Final tax upon filing T1 personal tax return

Selling price		600,000
less: ACB	400,000	
Commission	22,000	
Legal and accounting fee	4,000	
		<u>(426,000)</u>
Capital gain		<u>174,000</u>
Taxable Capital gain - 50% of capital gain		<u>87,000</u>
Final income tax (estimated at approximately 32%) (Notes 3 & 4)		28,000
Less: Withholding tax paid for CC (see above)		<u>(50,000)</u>
Tax refund to NR owner - summer of the following year		<u>\$ 22,000</u>

Notes:

- 1 Assume that all furniture and fixtures are included in the purchase and selling prices.
- 2 The lawyer will generally hold back \$150,000 (25% of \$600,000) until CC is received, but could be more than 25% under some circumstances.
- 3 The final income tax will be calculated at progressive rates from 22 to 43% (for 2010).
- 4 The calculation of the final income tax assumes that there is no recapture of CCA.
- 5 Please refer to our pamphlet "Tax Consideration for Non-Resident Individuals Investing in Canadian Rental Real Estate".