S+C Partners LLP
CHARTERED ACCOUNTANTS

Investing in Income Producing Real Estate

SPECIAL REPORT

Background

In light of recent stock market conditions, and increasing real estate valuations across the country, many investors are entertaining the thought of purchasing an income producing real estate property to diversify their investment asset mix. The chase for yield has caused many investors to consider owning a rental property to improve their investment return on low yielding bonds and guaranteed investment certificates.

We have prepared this white paper to discuss some of the issues you need to consider about owning real estate: ownership structure, financing, tax implications, cash flow and exit strategies.

Kalin L. McDonald, CPA, CA
Client Service Partner

Structure

Legal title to a real estate property may be held in many ways:

1. Personally by an individual;
2. Jointly (or as tenants in common) by more than one individual;
3. By a corporation;
4. By a bare trustee corporation in trust for another party;
5. By a partnership (limited or otherwise); or
6. By a family trust;

Our recommendations to clients on how real estate investments should be owned are based on an analysis of the risks associated with owning the property, the pre-existing assets of that individual, and the individual's intention with respect to financing the property. Certainly, environmental regulations across Canada are of concern to many real estate investors who prefer to segregate the risks of environmental contamination from other assets that they may own.

Generally speaking, our recommendation is that most real estate be owned corporately to separate the risks of owning and operating the property from the other business operations or risks of the individual investor. Environmental risks associated with a commercial property where manufacturing and processing activities are taking place, usually leads quickly to a recommendation in favour of corporate ownership.

A corporation may have any number of shareholders that may or not include: individuals, other holding companies or family trusts.

Financing

Most real estate acquisitions are financed with some amount of arms' length debt, possibly raised with the help of a mortgage broker or financial institution. Many real estate lenders have a cap on how much they are prepared to loan against a property (loan to value ratio). Often this limit is 60%. The Business Development Bank of Canada often increases this limit for owner occupied real estate opportunities, in some cases to 80%.

REAL LIFE EXAMPLE

We recently assisted a client in acquiring a 15,000 square foot building with a single retail tenant for a purchase price of $6.6 million. Financing was arranged with a Canadian Chartered Bank at a very reasonable rate of 4.19% for a 5 year initial term of $4,350,000 and with an amortization period of 20 years. This financing was equal to a raise of 66% of the purchase price of the property. Our client arranged to contribute the difference directly to the acquisition company to close the transaction.

In the case of a more modest real estate acquisition like a residential condominium or residential home, it is common for the lender to require that the debt (usually registered in the form of a mortgage against the property) be guaranteed by the borrower or the principals behind the corporation undertaking the transaction. This guarantee is a promise by the guarantor that if the mortgage is not repaid that the guarantor will make good on the full amount of the mortgage.

Tax implications of a real estate purchase

What is highlighted here is that from a tax perspective, investors are indifferent to owning the real estate corporately or personally.

Corporate taxes vs. Personal taxes

The computation of income from income producing real estate is the same for all investors. Expenses related to the real estate are deducted from the revenues collected. In most cases in the corporate setting the income will be taxed at the investment income rate of 46.17%; (calendar year 2015) which includes an element of refundable tax.

In the case of a personal investor, the rental income is added to the income already being reported on the tax return of the person. In the case of an individual paying tax at the highest rate in the province of Ontario in 2015 the rate is 49.53%. Individuals with taxable income between $150,000 and $220,000 pay tax at a rate of 47.97%. What is highlighted here is that from a tax perspective, investors are largely indifferent to owning the real estate corporately or personally. There is a slight bias (1.8% to 3.36%) to owning the property in a corporate setting.

On a personal tax return, rental income is reported on Form T776, Statement of Real Estate Rentals which is easily downloaded from the Canada Revenue Agency website. In the corporate setting, the corporate tax return reporting is more complicated and involves several different schedules that accompany the Form T2, Corporate Income Tax Return.

Tax implications of a real estate purchase – Part 2

Depreciation

A properly purchased and structured real estate property can provide good cash flow to an investor. The enhancement to cash flow is because of the depreciation tax shield that results from owning a real estate asset. The building portion of a rental property may be depreciated at 4% per annum on a declining balance basis and at 2% in the year of acquisition. In some situations we advocate buying the real estate asset and then declaring a year-end immediately to get the half-year rule for depreciation out of the way. Depreciation may not be claimed to increase the loss of an investor. Land is not depreciable.

REAL LIFE EXAMPLE

Our client determined that the value of the building was $5,035,600 and the land value was $1,678,525 when land transfer tax and disbursements and fees were included. As a result, in the first year of ownership the depreciation that could be claimed totaled $100,712 ($5,035,600 x 4% x 50% in the year of purchase).

Tax implications of a real estate purchase – Part 3

Any HST paid on the expenses of operating the rental property would be claimed as an input tax credit and offset the HST collected from the commercial tenant.

HST

In the case of a commercial rental property, HST would be collected from the tenant on a monthly basis. Similarly if the tenant has undertaken to pay property taxes and common area expenses like insurance or utilities, these additional payments would also attract HST. In most cases there would be a quarterly obligation to pay an instalment towards an annual HST liability or to file an HST return.

Any HST paid on the expenses of operating the rental property would be claimed as an input tax credit and offset the HST collected from the commercial tenant. It is standard operating procedure to apply for an HST account immediately upon incorporation so that HST does not have to be transacted in cash on closing in the commercial context.

On a newly constructed residential property it is common for the purchaser to pay HST on the closing of the new property. Often a portion of this HST is rebated back to the builder in the form of the New Home Buyers' Rebate and the purchase price is reduced by the builder. The rental of a residential property is exempt from HST. HST is not collected by a residential landlord. There is no HST relief for input tax credits paid on the expenses of the residential property.

Expenses

In many cases, the greatest expense in the case of a leveraged rental property acquisition is interest. Very often this financing is stretched out as far as possible to enhance the cash flow to the investor. It is not atypical to see situations where the financing has been set over an amortization period of 20 years. Generally speaking the interest paid to the lender to purchase the property is deductible to the real estate investor.

REAL LIFE EXAMPLE

In the case of our client, the $4,350,000 mortgage advance resulted in a blended (principal and interest) monthly payment of $26,714 and an interest deduction in year 1 of $177,850.

Other expenses

Repairs and maintenance, property taxes, utilities, insurance (tenant package and owner's liability), bank charges, snow removal, landscaping, concierge services are examples of expenses that are deductible against the annual computation of rental income.

Cash flow

A triple net lease (Net-Net-Net or NNN) is a lease agreement, where the tenant or lessee agrees to pay all real estate taxes, building insurance, and maintenance on the property.

Cash flow from an income producing property with a steady and reliable tenancy is rather straight forward. Rental cheques or electronic transfers are deposited monthly as agreed in the lease, expenses are paid monthly based on supplier billings and the mortgage payment is usually an automatic transfer to the financial institution.

Cash flow can tighten where quarterly HST remittances need to be made or where other unanticipated expenses arise that are the responsibility of the landlord. In commercial settings, most leases are "Triple net." A triple net lease (Net-Net-Net or NNN) is a lease agreement, where the tenant or lessee agrees to pay all real estate taxes, building insurance, and maintenance on the property. In such a lease, the tenant or lessee is responsible for all costs associated with the repair and maintenance of any common area. This form of lease is most frequently used for commercial freestanding buildings.

In residential settings, the leases in our experience are gross leases. The residential tenant pays the gross lease amount monthly and makes some contribution towards utilities. The landlord typically pays the property taxes and maintenance on the property, usually save and except wear and tear damage caused to the property by the residential tenant that may be backed by a damage deposit (think student housing). In the case of a gross lease, the repairs to the property (water leaks, and broken kitchen appliances) are at the cost of the landlord. This makes the setting of the monthly gross lease amount important to ensure that the investor is able to establish adequate reserves for the aging of the property and its contents.

Cash flow – Part 2

Corporate taxes are usually not an important element of annual cash flow as the depreciation tax shield assists with keeping taxable income low. Further, most provinces have withdrawn their capital tax regimes which affected many incorporated landlords.

REAL LIFE EXAMPLE

The monthly rent collected by our client totalled $63,555.89 including HST, common area fees ($1.50 per square foot), property taxes ($11.60 per square foot) and base rent ($29.87 per square foot). The monthly outflows of our client included a mortgage payment of $26,714, and municipal property taxes of $15,955. As a result there was positive cash flow generated of $20,886 before other annual costs were factored in like liability insurance, accounting fees, and bank charges.

Exit strategies

The sale of an income producing property will result in two things usually: a capital gain and a recapture of depreciation, assuming that a property is sold for more than it was purchased for after deducting real estate commissions, legal fees and other costs.

Capital gain

The price obtained from a buyer for the income producing property over and above its original adjusted cost base will be taxed as a capital gain. Capital gains are taxed preferentially in Canada, as only 50% of the gain forms part of taxable income. The adjusted cost base of an income producing property is usually equal to its cost plus disbursements: legal fees, and land transfer taxes typically.

REAL LIFE EXAMPLE

The adjusted cost base of our client's real estate purchase was computed as follows:

Purchase price:	$6,600,000
Land transfer tax (Ontario – not in Toronto)	97,475
Disbursements and fees (excluding HST)	16,650
	$6,714,125
Allocation to Land:	(1,678,525)
Cost of the building (basis for depreciation)	$5,035,600

As part of the purchase transaction, HST was paid on the disbursements and fees that will be claimed as input tax credit. Property taxes were prorated to give credit to the vendor for taxes paid during the year. Further, there was a proration of the commercial rent since the transaction closed during the month, together with the HST.

Exit strategies – Part 2

REAL LIFE EXAMPLE

If this building was sold for greater than $6,600,000 there would be a capital gain on the disposition. Assuming a disposition at $7,500,000 the capital gain would be computed as follows:

Proceeds	$7,500,000
Less: real estate commission at 5% plus HST at 13%	(375,000)
Less: legal fees	(5,000)
Net proceeds:	7,120,000
Less: adjusted cost base of land	(1,678,525)
Less: adjusted cost base of building	(5,035,600)
Capital gain	$405,875
Taxable capital gain (50%)	$202,938

A capital loss would result if the net proceeds were less than the adjusted cost base of the property (note that this applies only to the land portion). Capital losses may only be used to offset capital gains. A loss may be carried back 3 years for tax purposes and carried forward indefinitely.

Recapture

REAL LIFE EXAMPLE

If we continue the example set out on the previous page, let's assume a sale in year 3 during the year after some depreciation has been claimed against the building. Recapture occurs when the building is sold for an amount greater than its undepreciated capital cost.

Adjusted cost base of building	$5,035,600
Depreciation claimed in year 1 (2% - half year rule)	(100,712)
Undepreciated capital cost, end of year 1	4,934,888
Depreciation claimed in year 2 (4%)	(197,396)
Undepreciated capital cost, end of year 2	$4,737,492

Assuming the sale proceeds were $7.5 million as set out above, we quickly realize that the building did not depreciate in value during the ownership period.

In the year of disposition, the disposition proceeds are compared to the undepreciated capital cost, and if those proceeds are greater than that amount that depreciation is recaptured. Simply put, the depreciation becomes taxable income in the year of sale. The maximum amount of recapture is equal to the total depreciation claimed on the building.

In the case of our client, recaptured depreciation of $298,108 would be included in taxable income in year 3, the year of disposition. In the case of a rental property that was sold for less than its acquisition price it is possible for a terminal loss to arise where the net proceeds on disposal are less than the undepreciated capital cost amount. A terminal loss results in a deduction from taxable income.

Summary

Owning income producing real estate can be a good solution for the investor in search of yield. Structuring the acquisition is important as is lining up the financing for the property. The tax consequences of owning the property are more complex than other sources of income like salary or dividends.

About S+C Partners LLP

S+C Partners LLP provides first-class assurance, taxation and advisory services to successful enterprises to support their financial commitments and minimize tax liabilities.

We carry out our mission by providing our clients with timely, top-notch professional services throughout the year. S+C has recruited, developed and trained a first-class client service team to respond on a timely basis to requests for a broad range of professional services.

Based in Mississauga, Ontario, S+C has operated with the same core values of client focus, trust, teamwork, and excellence for more than 20 years. Today, S+C is led by a number of Client Service Partners, who are recognized leaders and specialists in their field. For more information on S+C Partners LLP, please call (905) 821-9215 or toll-free 1-866-965-1435 or visit us on the web at scpllp.com or email info@scpllp.com.

S+C Partners LLP has the experience to help you evaluate your options and determine the right succession planning strategy for your business. We can help you get the process started with an introductory meeting scheduled at your convenience.