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Tax Considerations for Non-Resident Individuals Investing in Canadian Real Estate (PRODUCING BUSINESS INCOME)

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The income from certain hotel properties at Whistler and Squamish (e.g. Westin Whistler, Hilton Whistler, Whistler Village Inn & Suites, Delta Whistler Village Suites, Adara Hotel, and Executive Suites Hotel & Resort Squamish) is treated as "business" income rather than "rental" income for Canadian tax purposes. This difference will have a significant impact on non-resident investors. In order for the income to be treated as business income, the property manager must apply for approval from CRA for the entire "hotel". That is, the decision to apply for business treatment is not up to each individual owner. Generally, this approval will only be given to properties which are operated as hotels.

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

1) Property Transfer Tax is payable at the time of purchase of real property. This tax is calculated on the fair market value of the property at the rate of: 1% on the first $200,000, 2% on the portion of the fair market value greater than $200,000 and up to $2,000,000, 3% on the portion of the fair market value greater than $2,000,000 and up to $3,000,000, and 5% on the portion of the fair market value greater than $3,000,000 if the property is residential. In addition, if the non-resident is a foreign national (not Canadian citizen or permanent resident) and purchases a residential property in the Greater Vancouver Regional District (does not include, for example, Whistler or Squamish), an additional 20% property transfer tax is payable upon purchase. Other acquisition costs may include inspection fees, appraisals and legal fees.

2) Municipal property taxes are due annually. In the year of purchase or sale, a pro-rata portion will be payable based upon the number of days that the property is owned in the year. The lawyer will do the adjustment in the Statement of Adjustments. After the year of purchase, property taxes must be paid each year (e.g. July 2 for Whistler) 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 0.5 to 1% of the value of the residential property. There are two main classes for property tax purposes: residential and commercial. These classes are not directly related to the classifications for income tax or GST purposes. Property tax on commercial property is significantly higher than residential. In Whistler, a reduction of property tax is available for the personal use portion of specified commercial properties (known as the STOCAP rules).

3) Additional school tax on high-valued properties does not apply to commercial units such as hotels. BC Speculation Tax does not apply to Whistler. The Empty Homes Tax does not apply to Whistler.

4) GST of 5% will be charged on the purchase of a newly built home. PST of 7% will be charged on chattels (furniture and fixtures) which are separately identified in the purchase agreement. PST is not charged on the

sale of residential property or commercial property. However, the cost of PST to a developer would normally be included in the selling price. Please refer to the GST section for more details.

Please note that the above is just a short summary of the property purchase and annual taxes and since a number of these taxes are new, current advice must be obtained from your realtor, lawyer and accountant.

Taxation of Business Income

1) Depending on the hotel, once the hotel has received permission from CRA for the income to be treated as business income, each individual owner may be required to apply for the Regulation 805 Waiver. If demanded by the hotel, this waiver should be submitted immediately after the closing date in the year of purchase (or by the 15th of the following month, at the latest). For subsequent years, it must be submitted before December 31 of the year before the applicable year (i.e. for the 2020 taxation year, it must be submitted by Dec. 31, 2019). CRA will send a confirmation for the waiver within a few months of it being submitted. The waiver is generally valid until December 31 of the applicable year. Starting in 2014, the annual Regulation 805 Waiver application by a non-resident owner is no longer required by CRA. However, some hotels still require the application for their own internal records.

2) **Gross room (business) revenue** is **not** subject to any **withholding tax**. This is very different from rental revenue, which is subject to a 25% withholding tax.

3) The non-resident is required to file a **T1 personal tax return and pay taxes by April 30 of the following year if** any taxes are payable. If no taxes are payable, the T1 must be filed by June 15**.** The taxable income will be subject to **progressive tax rates ranging from approximately 22% to 49%** for 2019.

4) A business income statement must be included with the T1. Eligible expenses will include advertising, insurance, management fees, property taxes, repairs, maintenance, strata fees, utilities and depreciation (referred to as "Capital Cost Allowance" or "CCA" – see below), etc. Most of these are paid for by the hotel and are automatically deducted from room revenues. In addition, expenses such as the interest expense portion of mortgage payments and accounting fees, which are paid directly by the owner, are deductible. Some expenses will also have to be prorated if there is personal use of the property.

5) In the calculation of taxable income, CCA may also be taken to reduce taxable income. The CCA rate on buildings is 4% and 20% on furniture and fixtures.

6) Business losses **can** be **carried back 3 years or forward 20 years**. This is different from rental losses, which cannot be carried back or forward by a non-resident. However, there are special "reasonable expectation of profit" rules, which allow CRA to disallow any loss if it cannot be reasonably anticipated that a profit will result within a reasonable period of time. The capital gain upon sale is not considered profit for the purpose of these rules. The rules are not specific, but, for example, losses for 10 continuous years with no hope for profit would likely be denied. On the other hand, losses for 3 or 4 years until the mortgage had been paid down and then profits thereafter would likely be acceptable if audited by CRA.

7) 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.

8) There is a relatively obscure rule regarding Canadian withholding tax on interest paid to a foreign bank regarding the earning of interest income in Canada. If you are considering borrowing funds in your home country to finance the purchase of a business property in Canada, please consult with a tax advisor.

Income Tax on disposition

1) Any gain on the disposition of business or 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 income 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% (on the land portion) and up to 50% (on the building portion) of the interim gain on sale**, plus up to 49% (for 2019) 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 <u>not</u> 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"** ("CC") (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 **CC, 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 lawyers may demand 50% withholding tax on the entire proceeds.) Therefore all knowledgeable purchasers will request a CC 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 % (or in some cases, up to 50%) of the entire purchase price until they receive the CC. 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 6 to 8 months for CRA to process a CC. 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 CC application form T2062, CRA requests information regarding the income earned from the property during the period of ownership. If revenues have been earned from the property but tax returns have not been filed, 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 CC. This obligation to file tax returns will apply even if there was a business loss each year.

   After the end of the taxation year in which the property is sold, the non-resident must file a T1 personal tax return to report the part year business income and the disposition of the property and calculate the actual gain and the final tax. In this calculation, the non-resident can deduct all related selling expenses such as commissions, legal fees and accounting fees. In addition, depending on the circumstances, the non-resident can normally claim **"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 48%** (for 2019). Since the total actual tax will be less than the withholding tax paid at the time of obtaining the CC, 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) Special rules which only apply to business property (i.e. not rental property) are the replacement property rules (e.g. similar to a US tax "Section 1031 tax deferred exchange"). Generally, if a business property is sold and another business property is purchased within the following taxation year, the tax on the gain on sale of the first property may be deferred until the sale of the second property. Please ask us if you think this may apply to you.

5) Complications which may arise in the application for CC may include: having never filed tax returns to report business revenues, joint title, title different from beneficial ownership, insufficient funds to pay out a mortgage, previous deemed disposition upon change of use, principal residence before change of use, previous inheritance

of property, joint owners each with different residence status, transfer upon divorce, vendor emigrating from Canada and other issues. We can help with these situations.

GST ("Goods and Services Tax")

GST on real property is very complex and depends on the situation of the vendor, the situation of the purchaser, the current and intended use of the unit (i.e. residential, personal or commercial), the current and intended use of the entire building, the type of property (e.g. new residential complex, used residential complex, hotel or similar property etc.), the property manager and the management contract. The following are some general guidelines but you must obtain professional advice before making any decisions regarding GST. These comments are written from a non-resident purchaser's point of view.

GST of 5% is charged on the sale of taxable supplies which are used in Canada. Taxable supplies will generally include commercial property (i.e. property rented on a nightly basis) and the rental of rooms on a nightly basis.

Acquisition of property:

A purchaser who is registered for GST can claim a refund (Input Tax Credit – "ITC") of the GST paid on the purchase of a commercial property. Therefore, most purchasers will register for GST. A property will be considered a commercial property if it is used all or substantially all (generally considered to be more than 90%) for short-term (e.g. nightly) rentals. In the most common scenario, a registered vendor sells a commercial property to a registered purchaser. If the purchaser registers for GST before the "closing" (possession) date, the GST will usually be waived on the sale and purchase. If the purchaser is not registered by the closing date, the GST cannot be waived (i.e. will have to be paid). However, the purchaser can register at a later date and claim the ITC on their first GST return.

In order to claim the full ITC, the property must be used at least 90% of the time for nightly rentals. If the property is used between 50 and 90% for rental purposes, the ITC must be prorated for the amount of personal use. If the property is used more than 50% for personal use, neither the waiver of GST nor an ITC can be claimed. This also applies to GST that was waived on the purchase of property. The GST may be required to be fully or partially repaid depending on the personal use percentage.

The calculation of the personal use percentage is very complex and depends on many factors, including personal use days, days rented, vacancy, occupancy, seasonal use, availability, intention, ease of access and other similar factors.

A registered purchaser can also claim ITCs for the GST paid on acquisition fees (e.g. inspection, appraisal and legal) and the purchase of furniture, fixtures and improvements.

The GST will not be applicable to the sale and purchase of a "used residential" home, no matter how it will be used.

Change of use:

There are special rules for the full or partial change of use of the property. These are generally not applicable to a hotel property as the personal use is limited by contract.

Nightly rentals:

GST must be charged on business revenue earned on a nightly basis. Generally speaking, GST charged and collected must be remitted to CRA and GST paid on purchases and expenses can be claimed as a refund by GST registrants.

The property manager will charge and collect the GST on the nightly rentals. The property manager will then either remit the GST collected directly to CRA monthly, or forward the GST to the owner. The property manager may require the owner to sign a special election in order to remit the GST directly to CRA.

It is important to know how the property manager will handle GST and, if required, we can ask on the owner's behalf. If the owner receives the GST from the property manager, they must pay it to CRA when the annual GST return is filed. This is called GST Payable.

GST return:

Generally, the GST return is prepared and filed annually, on a calendar basis. The deadline for filing is March 31 of the following year.

If the GST collected by the property manager is sent to the owner, this "GST payable" must be reported and paid by the owner to CRA. If the property manager remits the GST collected directly to CRA, there is no GST Payable to report on the GST return.

The registered owner may also claim ITCs for the GST included in expenses paid (e.g. repairs, maintenance, management fees, strata fees, utilities, etc.). Any ITC must be prorated for personal use.

Sale:

GST must be charged on the sale of a commercial property. However, if the purchaser is also registered and will use the property for commercial purposes (e.g. nightly rental), the vendor may agree to waive the GST.

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 property manager 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 will 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, monthly rental and ownership without rent.

Contact

For further details or questions, please contact Don Nishio.

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Tax Considerations for Non-Resident Individuals Investing in Canadian Rental Real Estate

Example Calculation

October 10, 2019

Example:

	File T1
Business Revenue	$ 40,000
Expenses	
Advertising (eg. TW)	1,000
Insurance	500
Interest	8,000
Management Fee	14,000
Property Tax	3,500
Repairs and Maintenance	4,000
Professional Fees	700
Utilities	1,000
	32,700
Net Income before Capital	7,300
Capital Cost Allowance (optional)	(4,000)
Net Income	3,300
Income Tax (eg. Net Income x 22%)	726

Notes:

1) No tax is withheld.

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

October 10, 2019

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		
			(426,000)	
Capital gain			174,000	
Taxable Capital gain - 50% of capital gain			87,000	
Final income tax (estimated at approximately 32%) (Notes 3 & 4)				28,000
Less: Withholding tax paid for CC (see above)				(50,000)
	Tax refund to NR owner - summer of the following year		$	22,000

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 the 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 48% (for 2019).

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".