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Tax Considerations for Non-Resident Individuals Investing in Canadian Rental Real Estate (RENTED NIGHTLY)

October 10, 2019

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) An Additional School Tax is due annually. The tax applies to detached homes, stratified condominium or townhouse units, and most vacant land with an assessed value over $3,000,000. Non-stratified rental buildings with four or more housing units and commercial portion of mixed-used buildings are exempt from the tax. The tax is 0.2% on the residential portion assessed between $3,000,000 and $4,000,000 and 0.4% on the residential portion assessed over $4,000,000.

4) The BC Speculation Tax is also due annually. The tax is 0.5% of the assessed value of property for Canadian citizens and permanent residents of Canada who are not members of a satellite family, and 2% of the assessed value for foreign investors and satellite families. Properties that are used as qualifying long-term rentals are exempt from the tax. Currently this tax does not apply to properties in Whistler and some other areas in BC.

5) The Empty Homes Tax (also known as the Vacancy Tax) applies to properties unoccupied over 180 days only in the City of Vancouver (includes time looking for tenants, empty while listed for sale, unimproved / uninhabitable properties). The tax rate is 1% of the assessed taxable value of the property.

6) 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.

Income Tax on Rental Property 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 6%). 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 the non-resident will be ultimately responsible. It may be possible to apply for a waiver of penalties in certain circumstances and we can assist with this application.

2) The non-resident has a *second option* **after** the end of the taxation year. Assuming that the withholding tax has been correctly paid, 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 income tax return.** The taxable income will be subject to **progressive tax rates ranging from approximately 22% to 49%** for 2019. Since the income tax calculated in this manner will be 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 2019 taxation year, it may be filed up to December 31, 2021).

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. move to Canada) should normally not take any CCA during the period that he is renting it. This is to allow a tax election which would avoid the 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 this 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 <u>not</u> filed by June 30, a **penalty of 25% of gross rental revenue** will be assessed against the agent. This third option (NR6) is usually beneficial from a cash flow point of view. 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 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, or owner if self-managed) 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, potential treatment of income as business income and other similar issues.

9) Some rental properties, which are operated as a hotel, may qualify for treatment as "business income" as opposed to "rental income". This is 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.

Income Tax 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 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 up to 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 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 after the Contract of Purchase and Sale has been signed. 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 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 CC.

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, 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 49%** (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) 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) Complications which may arise in the application for CC may include: having never filed tax returns to report rental revenues, significant renovations, significant renovations without receipts, 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 individual 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.

GST will be charged by the vendor if the property is new construction or if the vendor was registered for GST, as it was rented 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 who plan to rent the property on a nightly basis 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 (deferred) 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 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 (e.g. for personal use), 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.

For GST purposes, regarding a change from residential (e.g. personal use) to commercial (e.g. nightly rental), there will be a deemed disposition and re-acquisition and an ITC may be able to be claimed in certain circumstances (e.g. if a new residential complex is purchased and then changed to commercial use).

For a change from commercial to residential, there may be a deemed sale and re-purchase at the current fair market value of the property for income tax purposes. For GST purposes, GST may have to be paid or repaid to CRA. There will be penalties and interest if a purchaser registers for GST and claims the waiver of GST or ITC but uses the property only, or principally, for personal purposes.

There may be additional complications for a mixed-use property (e.g. part year nightly rentals, part year monthly rentals and some 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.

Nightly rentals

Generally, GST must be charged on nightly rentals. 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.

If there is a property manager, they will generally charge and collect the GST on the nightly rentals. The property manager will 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.

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. If the property manager remits the GST collected directly to CRA, there is no GST payable to report on the GST return. The property manager may require a GST election form to be signed by the non-resident in order to collect and remit on behalf of the non-resident owner.

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.

If the property is used residential property and the vendor is not registered for GST, there is no GST on the sale.

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 have additional pamphlets regarding nightly rental producing business 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 Calculations of the Three Options

October 10, 2019

Examples: ***OPTIONS***

	1	**2**	**3**	
		File T1	**File NR6 & T1**	
Rental Revenue	$ 40,000	$ 40,000	$ 40,000	
Expenses				
Advertising (e.g. TW)	1,000	1,000	1,000	
Insurance	500	500	500	
Interest	8,000	8,000	8,000	
Management Fee	14,000	14,000	14,000	
Property Tax	3,500	3,500	3,500	
Repairs and Maintenance	4,000	4,000	4,000	
Professional Fees	200	700	1,100	
Utilities	1,000	1,000	1,000	
	32,200	32,700	33,100	
Net Income before Capital	7,800	7,300	6,900	*
Capital Cost Allowance (optional)	0	(4,000)	(4,000)	
Net Income	7,800	3,300	2,900	
Income Tax (e.g. Net Income x 25%)	0	825	725	
Tax withheld ($40,000 x 25%)	$ 10,000	$ 10,000	$ 1,725	*Note 2
Final Income Tax	$ 10,000	$ 825	$ 725	
Income Tax (Refund)	0	(9,175)	(1,000)	
Net cash inflow after tax (refund)	$ (2,200)	$ 6,475	$ 6,175	

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

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 49% (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".