CONDO INVESTMENT SHOULDN’T BE A TAX NIGHTMARE

Evelyn Juan / March 6, 2015

Jodi and Alex live in a four-bedroom home in Windsor, Ont., with their two sons, but want to invest in a one-bedroom condo in Toronto. They plan to purchase a pre-build in the Riverdale area for $255,000, rent it for $1,500 a month for at least five years, and then sell after the value rises. What tax issues should they consider before buying the condo?

WHO DO YOU CALL?

Tax experts. You need to know how CRA would view revenues from the condo’s rental income and what would trigger an audit.

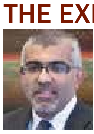
WHAT THEY SAY

Ali Raza Jaffer

The CRA can be harsh if you’re buying a condominium to flip. Some of my CRA contacts say they’re auditing every single condo that’s being flipped. There’s no CRA definition for flipping, but the CRA requires that you rent out the property for at least one year to be able to claim HST. But it all depends on what CRA decides. If you’re deemed to be flipping, 100% of the gain becomes taxable as business income. People usually invest in property thinking they’re only subject to 50% capital gains. If Jodi and Alex are planning to sell the place but aren’t able to rent it, the gain will likely be taxed as income.

But, they’ll likely be taxed on only 50% of the gain if they can rent the place for at least one year. Unlike those who buy a condo for investment purposes by renting it out, a flipper is someone who holds onto a property for a short period of time (generally less than a year) prior to selling it. If the condo is sold at a loss, that loss is generally treated as a capital loss whether the condo has been flipped or not.

THE EXPERTS



ALI RAZA JAFFER

president of AR Jaffer Professional Corp.

SABINA MEXIS

partner at Devry Smith Frank LLP

JOHN WATERS

vice-president and head of tax and estate planning at BMO Nesbitt Burns

If Jodi and Alex claim consistent rental losses for at least three years, CRA is more likely to audit them. And they have to be careful claiming depreciation. If they've got a profit of $1,000 and depreciation of $3,000, they can only claim $1,000 in depreciation. However, rental income and expenses must be claimed on the tax return every year so they can't carry those income or losses forward. In Ontario, the small business rate is 15.5%, but investment corporations are taxed at approximately 48%. To be taxed at the lower rate, the couple could set up a corporation to buy the condo. The corporation should have more than five employees so CRA will view it as an active small business. A small business doesn't just grant access to the lower tax rate; the main advantage is actually creditor-proofing. If Jodi and Alex default on any mortgages held by the corporation, the bank can only seize the corporation's property.

RULES ABOUT DEPRECIATION

Class 1: deduct 4% Capital Cost Allowance per year

- Class 1 includes most buildings acquired after 1987, and a condominium unit belongs to the same class as the building it's in.

Class 6: deduct 10% Capital Cost Allowance per year

- The frame must be made of log, stucco on frame, galvanized iron or corrugated metal.
- One of these three conditions also has to apply: the building was acquired before 1979, it has no footings or other base supports below ground level or it's used to gain income from farming or fishing.

Class 3: deduct 5% Capital Cost Allowance per year

- If you acquired a building before 1990 that does not fall into Class 6, you can include it in Class 3 if either:
- you acquired the building under the terms of a written agreement entered into before June 18, 1987; or
- the building was under construction by you or for you on June 18, 1987.

Source: Sabina Mexis and CRA

Sabina Mexis

Jodi and Alex will also be able to deduct expenses incurred to earn the income, such as property taxes, repairs and maintenance fees, paint, adding hardwood floors, and new appliances that are not capitalized (unless they are a specialized type of appliance or machine, such as a compressor).

But they'll have to be careful when making improvements to the property. With expenses of an enduring nature—like putting a roof on a house, or building a new garage—you have to capitalize the expense. The amortization of capital expenses depends on the type of assets to be depreciated. These are grouped into classes, and a specific rate of capital cost allowance applies to each. For example, a building may be amortized at 4%, 5% or 10% annually, depending on when it was acquired, and what it is constructed out of (see "Rules about

WHAT YOU LEARN

Be aware of what CRA is looking at when buying a condominium for investment. The taxes could be harsh if you're not looking to rent the property out; also, claiming losses consistently could result in being audited. To prepare for potential CRA audits, gather depreciation,” above). Jodi and Alex are acquiring a condo built after 1987, so it’ll likely be depreciated at 4%. The CRA won’t generally audit somebody who has one or more investment properties, provided they’re not aggressively claiming deductions. If CRA sees you purchasing and selling properties, say, every two years, and claiming them as principal residences while you’re actually renting them out, they may audit you and tax the proceeds of the sale as business income.

> research to prove you’re investing for profit.

John Waters

If CRA sees consecutive years of losses, the first thing it’ll ask is, “What sort of profit expectation did you have, and how reasonable was it?” So they should be realistic about the expenses they might incur and the level of income they think they can generate. Also consider the location—will they be able to find good tenants? What might be the return on capital? Will they pay significant expenses for the upkeep? They can talk to other landlords in the area, or to real estate agents. They can ask what type of rent they’re getting and what expenses they’re incurring. They should keep track of their expenses and have invoices. It’s about having a paper trail to support that you’ve bought the property with the intention to rent it out for profit.

by **Evelyn Juan**, a Toronto-based financial writer