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Tax Considerations for Non-Resident Individuals Investing in Canadian Real Estate (producing Business Income)

May 8, 2009

The income from certain properties at Whistler (e.g. Westin Hotel, Hilton Whistler, Whistler Village Inn & Suites, Delta Whistler Village Suites) 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 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 payable annually and you will be required to pay that portion of the annual amount based upon the number of days you own the property in the year of acquisition. The amount is based upon the assessed value and the “mill rate” set by the municipality however, as a general “rule of thumb”, annual property taxes are very approximately 0.5 to 1% of the value of the property.
- 3) British Columbia Social Service Tax (commonly called PST) of 7% will be charged on chattels (furniture and fixtures) which are separately identified in the purchase agreement.

Taxation of Business Income

- 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) Once the hotel has received permission from CRA for the income to be treated as business income, each individual owner must apply for an annual update to the Regulation 805 Waiver. 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 2010 taxation year, it must be submitted by December 31, 2009). Some hotels require the individual owners to submit the annual update and some hotels will do it for the owner. Some hotels will only do it in certain years (e.g. Not the year of acquisition but for subsequent years). CRA will send an approval for the waiver within a few months of it being submitted.
- 3) **Gross room revenue is not subject to any withholding tax.** This is very different from rental revenue, which is subject to a 25% withholding tax.

- 4) 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 24% to 43%** for 2008.
- 5) A business income statement must be included with the T1. Eligible expenses will include advertising, depreciation (referred to as “Capital Cost Allowance” or “CCA” – see below), insurance, management fees, property taxes, repairs, maintenance, strata fees, insurance and utilities etc. Most of these are paid for by the hotel and 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.
- 6) 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.
- 7) Business losses **can** be carried back 3 years or **forward 10 years**. This is different from rental losses, which cannot be carried 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.
- 8) Tax planning issues which should be discussed include ownership structure, management of foreign exchange and real estate investment risks, 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) 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.

Taxation on disposition

- 1) Any gain on the disposition of business or personal 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, commission expenses, legal 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 **“Clearance Certificate”** (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 Clearance Certificate, 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 some purchaser’s lawyers may demand 50% withholding tax on the entire proceeds.) Therefore, all knowledgeable purchasers will request a Clearance Certificate 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 he receives the Clearance Certificate. 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 8 to 10 weeks for CRA to process a Clearance Certificate. 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 income earned from the property during the period of ownership. If income has been earned from the property but 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 Clearance Certificate.

- 3) **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 of the actual gain, he can deduct all related selling expenses such as commissions and legal and accounting fees. In addition, depending on the circumstances, he 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 **24% to 43%** (for 2008) and if the total tax is less than the withholding tax paid at the time of obtaining the Clearance Certificate, 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. 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.

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, 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.

Generally, 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 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 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 business purposes. There are a number of methods to calculate the personal use percentage, but they are very complex. If the property is used

between 50 and 90% for business purposes, the ITC must be prorated for the amount of personal use. Should the property be used more than 50% for personal use, neither the waiver of GST or 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.

GST must also be paid on the acquisition of chattels (furniture and fixtures) which are identified on the purchase agreement. This GST can also be waived but a Form 44 election must be signed by the vendor and purchaser. Alternatively, the purchaser can pay the GST and claim an ITC.

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.

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.

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. Therefore, GST will have no net impact on the owner, other than the preparation of forms and the fees to do this.

The property manager will 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, he must pay it to CRA when he files the annual GST return. 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 registered owner may also claim ITCs for the GST included in expenses paid (e.g. TV, repairs, maintenance, management fees, BC Hydro, telephone, 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 the services noted on the above pamphlet, we would request that you complete our Questionnaire.

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

Contact

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

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

Example Calculation

March 5, 2008

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
	<u>32,700</u>
Net Income before Capital	7,300
Capital Cost Allowance (optional)	<u>(4,000)</u>
Net Income	<u>3,300</u>
Income Tax (eg. Net Income x 23%)	<u>760</u>

Notes:

- 1) No tax is withheld.

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

March 5,
2008

Assumptions:

Purchase (Note 1)		
Purchase price	\$	400,000
Property transfer tax		6,000
Legal fees on purchase		1,000
Tax Cost ("Adjusted cost base" - "ACB")		407,000
Sale (Note 1)		
Selling price		607,000
Commission for selling		22,000
Legal and accounting fees for selling		2,000

Withholding tax at time of disposition to obtain Clearance Certificate

Selling price	\$	607,000
less:ACB		(407,000)
Interim capital gain		200,000
Withholding tax at 25%		25%
Withholding tax payable (Note 2)		50,000

Final tax upon filing T1 personal tax return

Selling price	607,000
less:ACB	407,000
Commission	22,000
Legal and accounting fee	2,000
	(431,000)
Capital gain	176,000
Taxable Capital gain - 50% of capital gain	88,000
Final income tax (estimated at approximately 31%) (Notes 3 & 4)	28,000
Less: Withholding tax paid for Clearance Certificate	(50,000)
Refund	\$ 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 \$151,750 (25% of \$607,000) until the Certificate is received.
- 3 The final income tax will be calculated at progressive rates from 24 to 43% (for 2008).
- 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".