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Tax Considerations for Non-Resident Individuals Investing in Canadian Rental Real Estate (rented nightly)

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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. Thereafter, you must pay on an annual 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. Property tax on commercial property is significantly higher than residential. Commencing in 2007, a reduction of property tax is available for the personal use portion of commercial property.

Taxation of 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 which should have been withheld. In addition, interest will be charged at CRA’s “prescribed rate” (currently 9%). 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 if the property is still owned, the non-resident will be ultimately responsible.
- 2) The non-resident has a *second option* **after** the end of the taxation year. He 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 tax return**. The taxable income will be subject to **progressive tax rates ranging from approximately 24% to 43%** for 2008. If the income tax calculated in this manner is 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 2008 taxation year, it may be filed up to December 31, 2010). This option is normally beneficial and will result in a refund as rental expenses will usually cause income taxes to be less than the taxes withheld (25% of gross revenue).
- 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. retire to Canada) should normally not take any CCA during the period that he is renting it. This is to avoid 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 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 not filed by June 30, a **penalty of 25% of gross rental revenue** will be assessed against the agent. This third option is usually beneficial from a cash flow point of view if there are any rental expenses. 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 payable or 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) 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, 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 will be 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.

Taxation 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 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 expenses 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 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 Clearance Certificate.

- 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, 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".

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% (6% prior to 2008) 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.

If you buy a used condo, which was previously used personally (a "used residential complex"), there will be no GST on the purchase.

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 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.

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.

Change of use:

There are special rules for the full or partial change of use of the property. For example, regarding a change from residential to commercial, 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 and GST may have to be paid to the CRA. There will be penalties and interest if a purchaser registers for GST and claims the waiver or ITC but only uses the property for personal purposes.

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

Nightly rentals

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

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, 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.

If the property is used residential property, 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 agent or tenant 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 (Cantonese or Mandarin), Bernard Lo (Cantonese).

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

Example Calculations of the Three Options

Jan. 9, 2008

Examples:	OPTIONS		
	1	2	3
		File T1	File NR6 & T1
Rental Revenue	\$ 40,000	\$ 40,000	\$ 40,000
Expenses			
Advertising (eg. 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
	<u>32,200</u>	<u>32,700</u>	<u>33,100</u>
Net Income before Capital	7,800	7,300	6,900*
Capital Cost Allowance (optional)	0	(4,000)	(4,000)
Net Income	<u>7,800</u>	<u>3,300</u>	<u>2,900</u>
Income Tax (eg. Net Income x 25%)	0	<u>825</u>	<u>725</u>
Tax withheld (\$40,000 x 25%)	<u>\$ 10,000</u>	\$ 10,000	\$ 1,725 *Note 2
Final Income Tax	<u>\$ 10,000</u>	<u>\$ 825</u>	<u>\$ 725</u>
Income Tax (Refund)	<u>0</u>	<u>(9,175)</u>	<u>(1,000)</u>
Net cash inflow after tax (refund)	<u>\$ (2,200)</u>	<u>\$ 6,475</u>	<u>\$ 6,175</u>

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**

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.