TAXATION OF RENTAL INCOME

There are a number of reasons why many Canadians have decided, over the past decade or so, to acquire residential rental property (or property they intend to use as or turn into residential rental property). First of all, interest rates have been at or near historic lows, meaning that returns from the usual interest-bearing savings and investment vehicles have been dismal. The other side of that coin is that those low interest rates have driven down the cost of financing and carrying a rental property, increasing the profit margin to be realized by renting them out.

At the same time, real estate values in most Canadian cities have been on a steady upward trajectory, and that has had two consequences. An investor in rental residential real estate can be reasonably certain that the value of the property will increase over its purchase price during the period of ownership. As well, the same rising real estate values have priced many Canadians, especially younger Canadians, out of the home ownership market, creating a greater demand for rental residential housing.

What is rental income?

Rental income is income earned whenever a property owner allows someone else to occupy or use that property. It doesn't matter, for tax purposes, whether the property rented is a house, an apartment, a room in a house or apartment, or other type of property (e.g., a mobile home).

In the majority of situations, income earned by a property owner from renting property is treated, for tax purposes, as rental income. In a minority of such situations, that income is considered business income, and the difference comes down to the number of types of services provided to the tenants.

Example

An individual purchases a house in a university town. The house has four bedrooms, and the individual rents out each bedroom to a single tenant.

In most such cases, the rent charged to each tenant covers their exclusive use of their bedroom and the right to use common space, like a living room, kitchen, and bathroom. Often, the rent paid will also include amenities like heat, hydro, water, internet, and perhaps parking and laundry facilities. In such situations, the income earned by the property owner/landlord will be treated as rental income for tax purposes.

In other instances, additional services are provided to the tenants as part of their rental agreement. Those services could include cleaning, security, and even meals. As the number of services provided increases, so does the likelihood that the landlord would be considered to be operating a business, and amounts paid by the tenants would be treated in the landlord's hands as business income.

It is readily apparent that there is no "hard" dividing line between rental income and business income situations. Details of how to determine the kind of income that is being received can, however, be found on the Canada Revenue Agency (CRA) website at https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/it434r-archived-rental-real-property-individual/archived-rental-real-property-individual.html.

The rules outlined below apply where income received from renting out a property is considered, for tax purposes, to be rental income.

Calculating and reporting rental income

The calculation of rental income for the year is quite straightforward.

Rental income is reported on a calendar year basis, so that rents paid between January 1 and December 31st of 2017 will be reported (together with income from any other sources) on the landlord's tax return for the 2017 tax year, which is filed in the spring of 2018. Rental income (and expenses) are summarized on Form T776, Statement of Real Estate Rentals. That form can be found on the CRA website at https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t776-statement-real-estate-rentals.html. The gross (total) rent received is then transferred to line 160 of the General Income Tax and Benefit Return, and net rental income is reported on line 126 of that Return.

The starting point is, of course, the rent amounts paid (or payable) throughout the year by the tenants. However, a landlord can receive other amounts from tenants including, for instance, a charge levied by the landlord to cancel a lease or to permit a subleasing arrangement by the tenant. All of these amounts are included in rental income.

Determining the tax treatment of expenses and deductions

As all property owners know, there is a seemingly endless list of costs and expenses which must be paid just to live in and maintain a house or other residential property. All those expenses — and more — are present where a property is used as a rental residential property. The difference, for landlords of rental properties, is that many of those unavoidable expenses are deductible for tax purposes. And, some of those which are not deductible in the current year can be amortized and deducted over a period of several years, on a schedule prescribed by law.

The distinction between expenses which can be deducted in full in the year in which they are incurred, and

those for which the deduction must be amortized over a longer period turns on whether a particular expense is a current or capital expense.

Briefly, the distinction is that current expenses are recurring expenses that provide a short-term benefit (and can be deducted in full in the year incurred), while capital expenses are those that provide a benefit that usually lasts for several years (and the cost of which must be amortized over that time period).

The characterization of a particular expense as being current or capital in nature has generated many disputes with the tax authorities and not a few court cases. The CRA has distilled the criteria used to make that determination, and the process by which the decision is made into a useful summary, with practical examples, which is set out below.

Does the expense provide a lasting benefit?

A capital expense generally gives a lasting benefit or advantage. For example, the cost of putting vinyl siding on the exterior walls of a wooden house is a capital expense.

A current expense is one that usually recurs after a short period. For example, the cost of painting the exterior of a wooden house is a current expense.

Does the expense maintain or improve the property?

The cost of a repair that improves a property beyond its original condition is probably a capital expense. If you replace wooden steps with concrete steps, the cost is a capital expense.

An expense that simply restores a property to its original condition is usually a current expense. For example, the cost of repairing wooden steps is a current expense.

Is the expense for a part of a property or for a separate asset?

The cost of replacing a separate asset within a property is a capital expense. For example, the cost of buying a refrigerator to use in your rental operation is a capital expense. This is the case because a refrigerator is a separate asset and is not a part of the building.

The cost of repairing a property by replacing one of its parts is usually a current expense. For instance, electrical wiring is part of a building. Therefore, an amount you spend to rewire is usually a current expense, as long as the rewiring does not improve the property beyond its original condition.

*What is the value of the expense?**

*(**Note**: Use this test only if you cannot determine whether an expense is capital or current by considering the three previous tests.)

Compare the cost of the expense to the value of the property. Generally, if the cost is of considerable value in relation to the property, it is a capital expense.

This test is not a determining factor by itself. You might spend a large amount of money for maintenance and repairs to your property all at once. If this cost was for ordinary maintenance that was not done when it was necessary, it is a maintenance expense, and you deduct it as a current expense.

Is the expense for repairs to the used property that you acquired made to put it in a suitable condition for use?

The cost of repairing used property you acquired to put in a suitable condition for use in your business is considered a capital expense even though in other circumstances it would be treated as a current operating expense.

Where the repairs were for ordinary maintenance of a property which you already had in your business, the expense is usually current.

Is the expense for repairs made to an asset in order to sell it?

The cost of repairs made in anticipation of selling a property, or as a condition of sale, is regarded as a capital expense.

Where the repairs would have been made anyway, but a sale was negotiated during the course of the repairs or after their completion, the expense is considered current.

What current expenses are deductible?

Once an expense is determined to be a current, rather than a capital expense, the question becomes whether such expense is deductible for tax purposes. The CRA's guide on the Taxation of Rental Income includes a summary of what is and isn't deductible, when it comes to the most common expenses incurred by landlords.

Property acquisition costs

Mortgage fees

Almost everyone who purchases a property with the intent of renting that property has to borrow money, in the form of a mortgage, to do so. A number of the costs associated with acquiring and servicing that mortgage will be deductible by the landlord, as follows:

Deductible loan fees include the following:

- mortgage applications, appraisals, processing and insurance fees;
- mortgage guarantee fees;
- mortgage brokerage and finder's fees; and
- legal fees related to mortgage financing.

While such costs are deductible, the tax rules impose a requirement that they be deducted over a five-year period. Specifically, 20% of such costs incurred can be deducted in the current year and each of the following four tax years. If the landlord/mortgage holder repays the mortgage within that five-year period, any remaining financing fees can be deducted at that time.

Mortgage and rental deposit interest paid

Interest charges paid on money borrowed to acquire or to improve a rental property can be deducted in full by the landlord/mortgage holder.

In many provinces, landlords can require a tenant to provide a deposit (usually equal to one month's rent, and used to pay the rent for the last month of the tenancy). Where a deposit is required, the landlord is usually required to pay interest to that tenant, and is then entitled to claim a deduction for the amount of interest paid.

Ongoing property costs

Maintenance and repair

As every property owner knows, there is almost always something that needs to be done by way of maintenance or repair. Those obligations arise equally, if not to a greater extent, when it comes to rental properties. The owner of a rental property can deduct the cost of paying someone to maintain the property or to do repairs, in the year those costs are paid. Where the landlord does the work him or herself, the cost of necessary materials purchased can be deducted: the cost of the landlord's labour cannot.

Landscaping costs

A landlord who pays someone to provide landscaping services (even if that is just lawn maintenance and snow shoveling) can deduct amounts paid for those services in the year payment is made.

Property taxes

Property taxes paid by the landlord to a municipality, province or territory in respect of the rental property (assuming that the property was, during that time, available for rent) are deductible in that year.

Utilities

Many rental accommodations include some (or, more rarely, all) utilities costs in the monthly rent charged. Usually, that includes the cost of heating, hydro, water and, sometimes, cable and internet. To the extent those costs are paid by the landlord, they are deductible as current expenses.

Property insurance

All property owners carry insurance against damage or destruction of their property, and against liability in the event that someone is injured on those premises – in fact, proof of such insurance must usually be provided in order to obtain mortgage financing. Premiums will likely be higher in the case of rental accommodations, and all such premiums paid are deductible by the landlord from rental income earned.

Where a landlord, usually in order to obtain an discount or preferential rate, pays insurance premiums in advance for more than one year, only the premiums which relate to coverage for the current year can be deducted for tax purposes in that year.

Administrative costs and professional fees

Even for a landlord who owns a single rental property, the payment of administrative costs and legal and accounting fees is unavoidable. However, most such costs can be deducted in the year they are incurred.

Advertising

While most advertising of rental properties is now done online or through the landlord's website, where costs are minimal, any such costs incurred are deductible. Costs for advertising through other means, like newspaper ads or listings in rental publications, are also deductible in the year they are paid.

Management and administrative fees/salaries and wages

A landlord who owns a multi-unit building, or multiple properties may engage a third party to find and approve tenants, or to collect rents from existing tenants. Fees paid to such third parties are deductible.

A landlord who owns a multi-unit building or several rental properties may also find it more cost-effective to employ someone to carry out administrative functions for all of those units or buildings. It's common, for instance, for there to be on on-site superintendent employed by the landlord in medium-sized or larger buildings. Where the landlord does employ one or more individuals to carry out management, or administrative or maintenance functions, the salaries and wage paid to those individuals is deductible for tax purposes.

A landlord who becomes an employer also, of course, takes on the obligation of withholding and remitting income taxes and Canada Pension Plan and Employment Insurance contributions and premiums from the employees' salaries or wages. At the same time, the landlord/employer is required to make the employer contribution with respect to CPP and EI, and that employer contribution is deductible for tax purposes.

Where the landlord/employer engages a third party payroll service or person to fulfill the payroll function for any employees, the cost of that service, or the salary paid to that person, are similarly deductible.

However, where a landlord carries out any or all of the above functions him or herself, and receives a salary for doing so, the cost of that salary is not deductible.

Legal and accounting fees

A landlord who owns just a single rental property will nonetheless be obligated to incur costs for legal and accounting services at some point. And, in many cases, incurring such costs upfront will minimize the risk of greater costs down the road.

Engaging a lawyer who is familiar with the legislation governing residential tenancies in the particular province to draft leases (or to customize standard forms) will ensure that the respective obligations of landlord and tenant are set out clearly, and that will hopefully minimize the risk of future disagreements or, worse, the need for litigation to resolve such disagreements. Similarly, engaging

an accountant to maintain an accurate record of income and expenses and to prepare a year-end financial statement can help to ensure that all legal and tax requirements are fulfilled. The professional who prepares and maintains those records can also make certain that all necessary and appropriate documentation (receipts, bank statements etc.) is obtained and kept, both for the filing of the annual return and in the event that the CRA ever requests proof of claims made in that return.

Such expenses, where incurred, are fully deductible by the landlord who pays them.

Office expenses

The cost of office materials used and consumed – pens, pencils, paper, printer cartridges and the like – are deductible in the current year. The cost of office equipment which has a longer life – computers, printers and office furniture, for instance – must be deducted over a period of time, through the capital cost allowance system.

Claiming capital cost allowance

Many, if not most, of the costs incurred by a rental property owner which are not currently deductible are eligible for a claim under the capital cost allowance system. That system essentially allows the cost of such acquisitions to be deducted over their useful life, with a specific percentage of such cost deducted each year.

The capital cost allowance system is straightforward in concept but can be complex in application. The basic rules provide that property which is eligible for CCA is grouped into classes (the idea being that similar types of property belong in the same class) and a prescribed percentage of the total cost of the property in a particular class is deducted each year by the taxpayer who owns that property. The balance left after that deduction becomes the amount on which the percentage CCA deduction is calculated in the following year.

The complexity of the CCA system arises from the large number of classes, and in the determination of the class in which a particular asset should be placed. For instance, the class(es) in which two very similar assets (for instance, two computers) belong may differ, depending on the year in which each computer was acquired.

That said, there are some very general "rules" with respect to the application of the capital cost allowance system to rental properties, as follows:

With very limited exceptions, land is not depreciable property and so is not eligible for any capital cost allowance claim.

Most rental buildings will belong to classes 1, 3, 31, or 32, depending on what the building is made of and the date that it is acquired. Owners of rental buildings can also include in those classes the following kinds of components which make up the building:

- electric wiring;
- lighting fixtures;
- plumbing;
- sprinkler systems;
- heating equipment;
- air conditioning equipment (other than window air conditioners); and
- elevators and escalators.

Generally, Class 1 (depreciable at a rate of 4%) includes most buildings acquired after 1987. Most buildings acquired before 1988 are included in Class 3 (depreciable at a rate of 5%). Finally, Classes 31 (depreciable at a rate of 5%) and 32 (depreciable at a rate of 10%) include multiple-unit residential buildings which have been certified by the Canada Mortgage and Housing Corporation.

The potential complexities of the CCA system are apparent, even from a brief summary. The need to determine the allocation of assets into CCA classes and the percentage depreciation which can be claimed for each is part of the preparation of the annual tax return, and landlords are well advised to seek professional advice in the preparation of those returns.