

Canadian Tax Planners Newsletter

November December 2006

In this edition of the Canadian Tax Planners Newsletter, we shall review the tax implications of earning rental income from either a rental property or a principal residence. A rental property could be a building that is rented to tenants on a full time basis, or it could be the family cottage, or ski chalet that is rented out a few weeks per year. Rental income generated from one's principal residence may consist of renting a portion of the structure to a student or family member, or it may be the rental of the entire residence when the family must move out of the city for a short period of time. Each of these scenarios has numerous tax traps.

Although the tax rules for rental properties appear straightforward, there are a number of nuances that may result in reassessments or tax planning opportunities for the owners of rental properties.

Rental Business Models

There are four basic business models for rental income and although the level of debt is a key differentiator, the tax planning opportunities will vary as well.

Positive Cash Flow Model For these properties, rental income exceeds expenses and the taxpayer intends to own the property for the foreseeable future

Break Even Model Although rental income may or may not cover the operating expenses, the objective is to hold the property for resale. Once the value of the property has increased to an appropriate level it will be sold. Normally, this will be treated as a capital gain

The Canadian Tax Planners Newsletter may not be copied or reproduced in any form without the expressed written consent of Canadian Tax Planners Limited, 30 Mapleton Place, London Ontario N6K 4A5
Copyrighted © Canadian Tax Planners 2006. Every effort has been made to ensure accuracy, but since comments are of a general nature, specific advice should be obtained from your professional advisor.
Canadian Publications Mail Product Sales Agreement #0483079. Annual subscription cost - \$80.00. Date of issue - November 2006. The Canadian Tax Planners is published six times per year in January, March, May, July, September and November.

Resale Model

Property is purchased at a bargain price, renovated and resold at a profit. Rental income is generated prior to the resale and the eventual gain is treated as a capital gain, assuming CRA does not take the position the taxpayer is in the business of fixing and reselling homes, as opposed to rental income

Principal Residence Model

An individual purchases a home that is significantly undervalued. He moves into the house, does some renovations and waits until the property increases in value. The house is sold and the process is repeated. Gains on this strategy are not taxable due to the principal residence exemption. Despite the tax advantages of this strategy, it has such a significant impact upon one's lifestyle, that it may not be suitable, other than as one time tactic

Ownership and Income Splitting

One of the most important decisions related to rental properties is to determine the registered owners of the property. Although ownership can be transferred among family members once a property has been owned for a few years, it is easier to establish the appropriate structure at the time of purchase. When a rental property is acquired, consideration should be given to allocating the ownership interest between the spouses and possibly adult children. Since most property is debt financed, each family member could make a financial contribution and take back debt to cover their share of the capital invested. Depending upon the cash flow projections, the ownership could be structured to allocate profit to lower income family members and any capital gains could be split between the owners, resulting in a reduced family tax liability. If an individual wishes to utilize rental property as an income splitting opportunity, consider the following:

- contact a lawyer to structure the transaction
- ensure each owner uses a portion of their capital
- it must not be a sham. In other words, the paperwork must reflect the actual transaction

Note – The remainder of this article is only available to subscribers of the Canadian Tax Planners Newsletter. If you elect to subscribe and wish to receive a copy of this newsletter, advise us accordingly and the complete article will be forwarded by return mail.