# Taxation of Canadian residential real estate: what non-residents need to know

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This article provides a quick summary of important points concerning the taxation of Canadian residential real estate for non-residents of Canada.

The Canadian real estate market has attracted a lot of attention from foreign buyers. The Toronto and Vancouver residential property markets have had extraordinary price increases (for example a 30 per cent increase in Toronto in one year). This has caused governments at all levels, federal, provincial and municipal, to focus on the area. The result has been:

1. An additional 15 per cent land transfer tax for foreign buyers for properties in a defined area of Southern Ontario (in and surrounding Toronto) and British Columbia (Vancouver area).
2. Increased enforcement of income tax compliance.
3. Changes in legislation to close a number of loopholes.

### Taxation on purchase

For a foreign buyer, a purchase of residential real estate in Southern Ontario and in the Vancouver area will now attract an additional 15 per cent land transfer tax. In Ontario, this is on top of a 2.5 per cent land transfer tax on value exceeding $2,000,000 (lower rates apply on the value below this). In addition, the City of Toronto levies a municipal land transfer tax at the same rate. This means that a non-resident buying a home in Toronto, for example, will now pay up to 20 per cent land transfer tax while a Canadian resident will pay 5 per cent.

The additional 15 per cent tax does not apply to Canadian citizens, even if they are non-residents of Canada.

There are certain exceptions for non-resident persons who become permanent residents of Canada. Because of this, persons who are planning to immigrate to Canada may wish to carefully consider the timing of the move and co-ordinate this with the timing of the purchase of a residence.

### Taxation on sale

On a sale of Canadian real estate, the first question which arises is whether any resulting gain is a capital gain or business income. A residential property which is purchased for personal use or for rental use and held for investment will be capital property. On sale, a gain will be a capital gain. However, a property which is purchased on speculation (an adventure in the nature of trade) will result in the gain on sale being treated as business income.

The important distinction is that business income is fully taxable whereas only 50 per cent of a capital gain is included in income.

The Canada Revenue Agency (CRA) is now aggressively following up on sales of real estate, examining the circumstances concerning the purchase and the sale, and the occurrence of other similar transactions (a pattern of buying and selling) with a view, in some cases, to challenge the capital gains treatment on sale. The “default” position is that the gain is business income and not a capital gain.

In order to support a gain being a capital gain, the seller may need to demonstrate that the property was purchased for personal use or long term investment, with no intention to sell the property in the short term. There is a great deal of uncertainty and subjectivity concerning this area, and advice should be obtained at the time of purchase as to the likely treatment on an eventual sale.

For a Canadian resident individual, the gain on sale of a principal residence is tax free. Non-residents have tried to use the same exemption through the use of Canadian resident trusts and other means. These planning possibilities have now been closed by new legislation.

Graduated tax rates apply for individuals, which vary based on the income level. The lowest tax rate for a non-resident is approximately 22 per cent, while the highest rate, reached at taxable income over $200,000 (roughly) will be about 49 per cent. The effective tax rate on a capital gain is half of these rates.

Ownership of Canadian real estate by foreign persons through a foreign corporation can result in a significant tax advantage because such a corporation will pay a 25 per cent corporate tax rate. Thus on a capital gain the effective tax rate will be 12.5 per cent.

**Clearance certificate procedure**

Where a non-resident sells Canadian real estate, the purchaser is required to withhold 25 per cent of the gross purchase price and remit this to CRA as a withholding tax. The vendor is required to obtain a clearance certificate from CRA which serves two purposes, a notification to CRA of the sale and a request for a reduction in the amount of the withholding tax. CRA will give permission to reduce the withholding tax to 25 per cent of the gain rather than 25 per cent of the gross proceeds. (This presumes that the gain is a capital gain and not business income, or else the rate of withholding is in fact 50 per cent.)

The clearance certificate process requires the filing of a form with CRA together with a considerable amount of back-up information. At least 30 days and preferably 60 days should be allowed for completion of this process prior to the date of the sale.

A Canadian tax return must be filed to report the sale. The withholding tax will be claimed there as a tax payment. Any excess will be refunded.

**Rental**

If the property is rented out, then the rental income will be subject to Canadian tax. This is often overlooked by non-residents, especially if the property produces losses.

There are two choices as to how the rental income can be treated. The default is that the tenant should remit to CRA 25 per cent withholding tax on the gross rental income. No reduction or offset is allowed for expenses. The alternative is to make an election to report the net rental income on an income tax return filed in Canada, in which case expenses may be deducted.

Many non-residents only become aware of the requirement to pay tax on rental income when the property is going to be sold and they apply for the clearance certificate.

The election to report the net rental income at regular Canadian income tax rates is usually beneficial compared to paying 25 per cent withholding on the gross rental income. This is particularly the case if a foreign corporation holds the real estate, since its corporate tax rate will only be 25 per cent in any event.

The election to pay tax on the net rental income must be made within two years of the end of the taxation year (six months if an application has been made to reduce the 25 per cent withholding tax from gross rental income to the estimated net rental income and to file on the net rental income basis). There is no provision to late file the election. However, CRA will allow a one-time late filing of elections going back to inception by administrative policy if it is done voluntarily by the taxpayer coming forward.

**Financing**

Interest expense incurred on debt used to purchase a Canadian residential property will not be deductible if the property is held for personal use. However, it will be deductible from the net rental income if the property is rented. One complication, however, is that a net rental loss cannot be used, except against other Canadian net rental income, and cannot be carried forward or back.

In addition, depending on how the financing is structured, the interest expense might be subject to non-resident withholding tax.

**Conclusions**

As can be seen from the discussion above, the issues involved in owning Canadian residential property are complex. There are both tax planning considerations and tax compliance issues (various tax filings which need to be done).

CRA is now aggressively enforcing the rules and following up on delinquent filers. They are examining land titles registries and tracing title changes to tax returns. Because of the political attention which this area has now attracted, further and even more aggressive action can be anticipated from CRA going forward.

Any non-resident of Canada who has ownership of Canadian real estate, or who is considering the purchase of Canadian real estate, should obtain professional advice.

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