# Investment Properties, Assignments, PREC's, Hold Co's, & Flips

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# Tax & Financing Considerations

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# Agenda

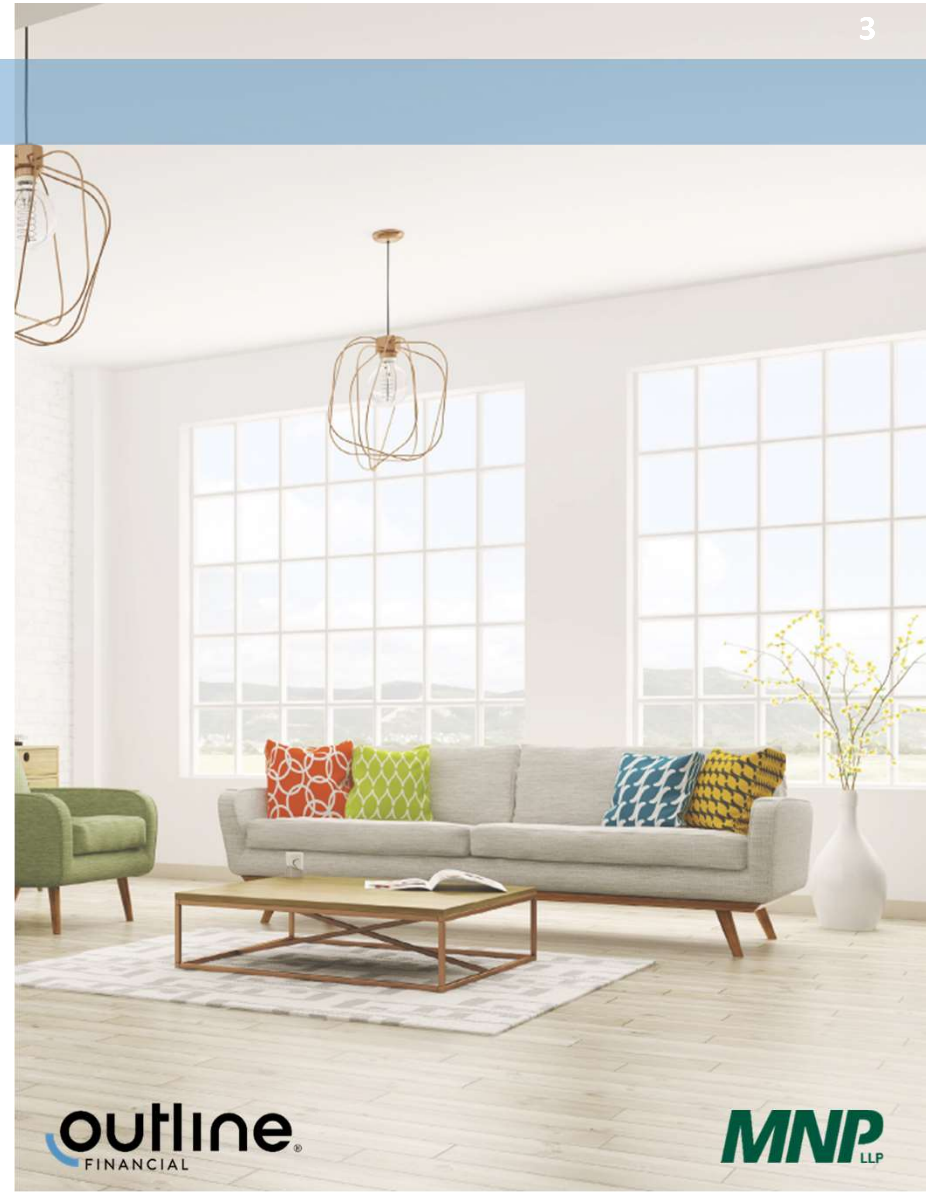
- ✓ Ways to build wealth through real estate
- ✓ Important factors to consider when finalizing a builder contract (beyond price and upgrades)
- ✓ Stages in the pre-construction purchase process and important steps along the way
- ✓ Client FAQ's when buying/financing a pre-construction
- ✓ Current tax environment for pre-construction & assignments
- ✓ Federal budget changes for assignments
- ✓ Flipping - what you need to know
- ✓ How to take title of an investment property
- ✓ Various HST related facts to new construction/flips

# Ways to build wealth through real estate:

1. Capital appreciation (as of June 2022, 10yr TRREB compound annual growth rate for detached was approximately 8.7%, for condos it was approximately 8.1%). Condo or house – property type considerations.

2. Leverage - you don't need a million dollars in cash to buy a million-dollar investment property.

Example scenario:
- Home purchase price 1mln
- Average annual increase in value 80k (assuming average rate of return at 8%)
- Minimum down payment 200k which one could consider 40% return on cash investment
- You can potentially also borrow funds for the down payment and closing costs (secured against your home or another property you own). More leverage increases risk so careful analysis is necessary.



# Ways to build wealth through real estate:

## 3. Cash flow

- What is the rental cap rate specific to this property - do rents cover the expenses and the mortgage payments
- Continuing with our example
- 1mln home
- 200k down payment
- 800k rest financed
- 4,295 / month estimated mortgage payment based on example 5%- and 30-year am. (not a quote)
- Other costs: property taxes, tenant insurance, maintenance costs and potentially utilities if not paid by tenant.
- What are the market rents for this property
- Is there a surplus or shortfall?

## 4. Right tax structure can also help build wealth (more on that later in the presentation)

# Other Factors to Consider When Investing in Rental Properties

Things to note:

- Property values will fluctuate – while long term forecast for the GTA is very positive, shorter term is much riskier.
- Transaction costs: closing costs, land transfer taxes and real estate fees needs to be factored in your net return rate.
- If leveraging, interest rate fluctuations will affect your carrying costs (monthly payments) and total costs of investment.
- Income taxes on appreciation upon sale

# NEW CONSTRUCTION: Factors to Consider When Finalizing a Builder Contract

- What is the purpose of this purchase: ***owner occupied or rental***? This will determine size of down payment required and amount of closing costs

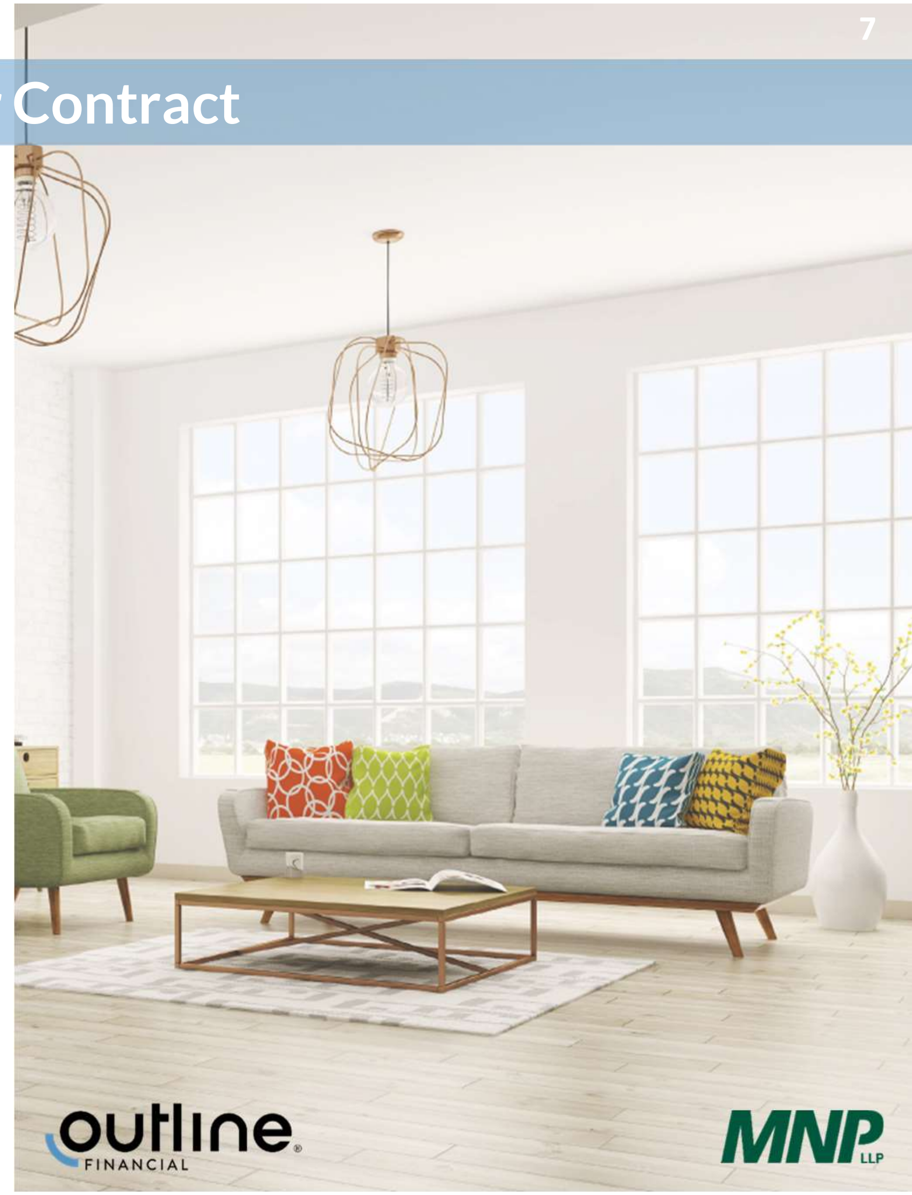
- Title to the property – ***personal or a holding company***?

- ***Assignment Clause*** allowing the buyer to assign their contract to a 3rd party at a pre-determined cost

# Factors to Consider When Finalizing a Builder Contract

- Real Estate ***Deposit Structure*** (best to limit clients' investment up front)

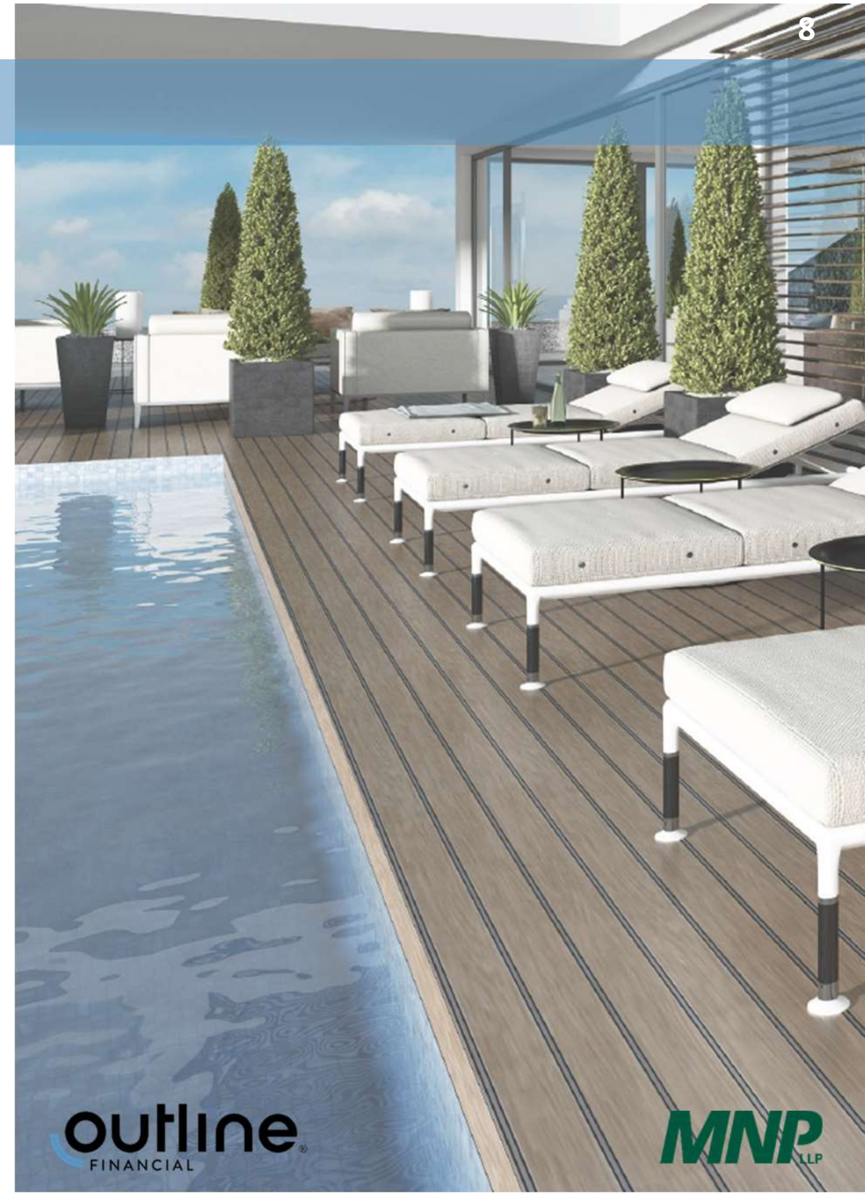
- ***Cap on Development Charges*** and potential Cost Escalation Clauses



# Stages in pre-construction purchase & financing

## Cooling Off Period

- Lawyer review of APS a must!
- Proof of financing and why do builders need it?
- Difference between Pre-Approval Letter or a Commitment and why it matters in the raising rate environment
- Deliver deposit cheques to the builder



# Stages in pre-construction purchase & financing

## Interim Occupancy Stage

- Facilitated through a real estate lawyer.
- Usually, final real estate deposit is due at this stage and formal mortgage commitment is required
- Clients get to occupy the unit but the condo corp. is not yet registered and client pays “rent” to the builder

# Stages in pre-construction purchase & financing

## Registration Stage

- This stage is also referred to as a ***final closing*** when your lawyer transfers title of the unit to you
- Closing costs are due at this stage including land transfer tax and regular closing costs plus builder deal specific costs such as development charges and potentially HST (more on that later)
- This is also when your mortgage gets activated and you start paying your property taxes, maintenance fees and mortgage payments


# Client FAQ's

- ✓ I **purchased my unit through an assignment** – how does that impact my financing?

- ✓ My property value has increased significantly since I purchased it – is there a way to access some of the equity at closing?

  ***Example***:
  - ➢ Bought a unit in 2017 for 500k
  - ➢ Market value at registration in 2022 is 800k
  - ➢ You could potentially close with a mortgage of 600k. Recoup your original deposit and pull additional cash out for other investments (**some conditions apply*)


# Client FAQ's

- ✓ I already paid 20% down payment via the real estate deposit to the builder, am I able to close the deal with less down payment and get some cash back for closing costs?
- ✓ Can the upgrades be included in the mortgage? What if I paid for them in cash. How about parking and locker?
- ✓ I want to sell my unit – is there a difference if I sell the contract on assignment or if I close on the deal first and then list for sale?

# Co-Branded Brochures

Ask us about co-branded brochures/materials

## Taxation of Real Estate Agents and Highlights for Your Clients

**Guest Presenter**: Jordan Weinberg, CPA, CA / Partner with MNP

### About MNP

- One of the largest accounting and advisory firms in Canada
- Our largest practice area in the GTA is real estate
- Our services include:
  - Audit & Accounting
  - Canadian Tax
  - International Tax
  - SR&ED
  - Corporate Finance
  - Valuations
  - M&A
  - Transaction Advisory
  - Enterprise Risk
  - Management Consulting
  - HR Consulting
  - Forensics / Litigation Support

MNP LLP

# The Current Tax Environment

## Why You Should Pay Attention:

- CRA has been auditing home sales in Toronto and Vancouver
- CRA has used powers under the Income Tax Act to demand information from developers regarding assignment sales, etc.
- Taxpayers claiming principal residence exemption or capital gains treatment are being re-assessed
- Gain is taxed as income
- HST applies to income sales

# Condominium / Home Sales - Audits BC

Results of audit activities related to real estate in British Columbia from April 2015 to March 2021:

| Programs | Number of files completed | Audit assessments* |
|---|---|---|
| Income tax | 3,000 | $665.5 million |
| GST | 2,099 | $212.7 million |
| GST New Housing and New Residential Rental Property Rebates | 5,321 | $24.9 million |
| **Total** | **10,420** | **$903.1 million** |

# Condominium / Home Sales - Audits Ontario

Results of audit activities related to real estate in Ontario from April 2015 to March 2021:

| Programs | Number of files completed | Audit assessments* |
|---|---|---|
| Income tax | 4,372 | $99.9 million |
| GST/HST | 2,285 | $267.4 million |
| GST/HST New Housing and New Residential Rental Property Rebates | 40,824 | $583.5 million |
| **Total** | **47,481** | **$950.8 million** |

# Condominium / Home Sales - Audits Ontario / BC

- BC audit results are driven by income tax and “flipping” properties (BC results are $665M vs $100M for ON)

- Ontario audit results are driven by GST/HST New Housing and New Residential Rental Property Rebates (ON results were $583M vs $24M for BC)

- There are 5 types of GST/HST rebates, all with separate qualifications

- Builders often credit GST/HST rebate to purchasers – documentation is sent to the CRA by the builder in some circumstances. Builders can be involved in CRA audits and bear costs related to providing information

# Taxation of Assignments

**Why are we even talking about HST?**

- Used residential sales are exempt for HST
- New construction is taxable for HST

# Taxation of Assignments

**Change:**

- On April 7, 2022 there is a proposed change. Effective date is for assignments entered after May 6, 2022.

- The proposed amendment would make all assignment sales in respect of a newly constructed or substantially renovated single unit residential complex or residential condominium unit taxable

- What was it before:

  - You had an 'out' if you the intention was to occupy as a primary residence

  - There is no more 'out'

# Taxation of Assignments

**Change (con't):**

- Clarifies how a deposit is treated:
  - Before: Any amount an assignor paid as a deposit to a builder is included in the consideration for a taxable assignment sale
  - Now: Deposit is excluded from proceeds. Need to watch wording…
- Overall takes away a lot of uncertainty on how assignments were treated

# Taxation of Assignments

**Example:** Couple in Ontario enters into agreement to purchase a pre-construction 1 bedroom condo in 2019 to be completed in 2023 and their **intention is to live in it**.

It is 2021 and the couple is expecting their first child. On Feb 1, 2022 they assign it as the space no longer of adequate size for their growing family.

They assign it for $150K more than they bought it and had $100K of deposits on hand.

- **Result before May 7**: No HST, capital gain on exit of $150K
- **Same example as above, but assign it on May 25, 2022. Result:** HST of $17K [$150K/1.13*.13], capital gain on exit of $133K [$150K - $17K]

*Remember the HST Act is separate and distinct from the Income Tax Act.

# What is a Flip – A Tax Perspective

- If intention is to earn income mainly from capital appreciation of property (i.e. Flipping a house), will be deemed inventory
- Generally speaking if property is rented out, lends to capital gain on sale, as sale will be on account of capital property
- Intention, intention, intention
- Document, document, document
- CRA view on principal residence vs. a flip: If you didn't live in it you better have a good personal reason you sold it.

# What is a Flip – A Tax Perspective

**But wait…Budget 2022**:

- *any person who sells a property they have held for less than 12 months would be subject to full taxation on their profits as business income, applying to residential properties sold on or after January 1, 2023. Exemptions would apply for Canadians who sell their home due to certain life circumstances, such as a death, disability, the birth of a child, a new job, or a divorce.*

**What does this mean**:

- The intention of having it as a rental property is in jeopardy.
- Going to rent it AND held under 12 months… it is just income as that's the tax law
- If sold under 12 months… either you were going to use it personally, and if not for a life circumstance (pre-defined), it is fully taxable

# Taxation of Real Property on Sale

- If not considered inventory the sale is considered capital property and subject to capital gains and recapture

- Capital gain (1/2 taxable)

  - 28% for highest marginal personal tax rate
  - 28% on sale through a corporation

- Recapture and business income, if any

  - 53%+ for highest marginal personal tax rate
  - 12.2% – 26.5% in corporation


# Other Budget Measures - Highlights

**Doubling of first-time home buyers tax credit** (*purchases after Jan 1, 2022*) to $10K from $5K → Worth about $1.5K in cash to the taxpayer

**Tax-Free First Home Savings Account (FHSA) - 2023**

- $8K annual contribution limit to $40K total
  - ➢ *Contribution is tax deductible against income*
  - ➢ *Grows tax free*

- Can't use this and Home Buyers Plan (HBP). So what's the difference:
  - ➢ *FHSA Pros:*
    - *Don't need to repay*
    - *If unused transfer to RRSP*
    - *Can transfer from RRSP to FHSA (subject to annual limits)*
  - ➢ *FHSA Cons:*
    - *Can't fund it in one-shot like the HBP*
    - *Does not appear to support a spousal contribution*


# HST on Flips & Renovations

- If you substantially renovate a property you need to charge HST on sale (unless it becomes your principal residence and you're not deemed a builder; except watch for new assignment rules)

- Substantial renovation is **greater than 90%** not including structural items
  - ➢ so a flip may or may not reach the threshold

- If charging HST, can claim ITCs

- The CRA of late has been very aggressive when it comes to HST


# HST on Rentals

- Short term rentals (under 30 days) are required to charge and remit HST (be very careful with small supplier threshold)

- Long-term residential rent is HST exempt


# Other HST – New Construction

- If you pay HST on new purchases watch for the various rebates:
  - GST/HST New Housing Rebate and related provincial programs
    - *Need to live in it (different than principal residence rules)*
  - GST/HST New Residential Rental Property Rebate and related provincial programs
    - *Lease for at least 1 year*

# How do I take title to an investment property

**Before we get started:**

- Generally there is NO tax advantage to holding a rental property in a corp. vs. personal on the performance of the rental itself

- There are potentially liability exposure benefits, can insurance deal with these instead?

- 99% of the time a non-high net worth individual has properties in a Holdco is because they have a completely separate business already incorporated OR they are buying properties with partners

# How do I take title to an investment property

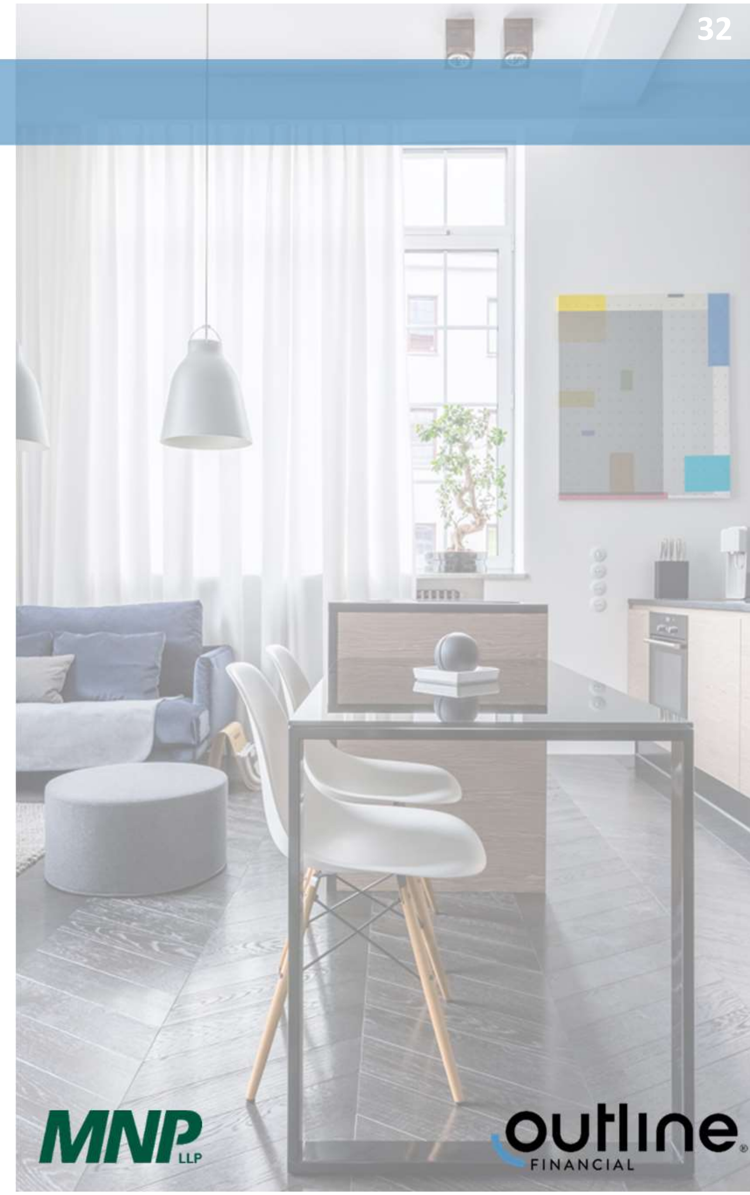

## Pros of Corporate Ownership:

- Can limit liability
- Can limit probate/ land transfer tax for ownership changes
- Good when multiple owners
- Flexibility in income allocations depending on structuring
- Potential benefits for estate planning (watch for double tax)

## Cons of Corporate Ownership:

- More onerous to get financing
- Interest rates can sometimes be higher
- More complexity → additional accounting, legal, banking fees
- Significantly more complicated tax situation on death of the tax payer

# How do I take title to an investment property




**Other Common Myths:**

- I can get the capital gains exemption if I sell the corporation that holds the rental real estate
- I have partners, and I can have one shareholder easily buy-out another shareholder
- There are more expenses we can deduct if we incorporate
- If I put the property in a corporation the bank/ private lender can't go after me personally

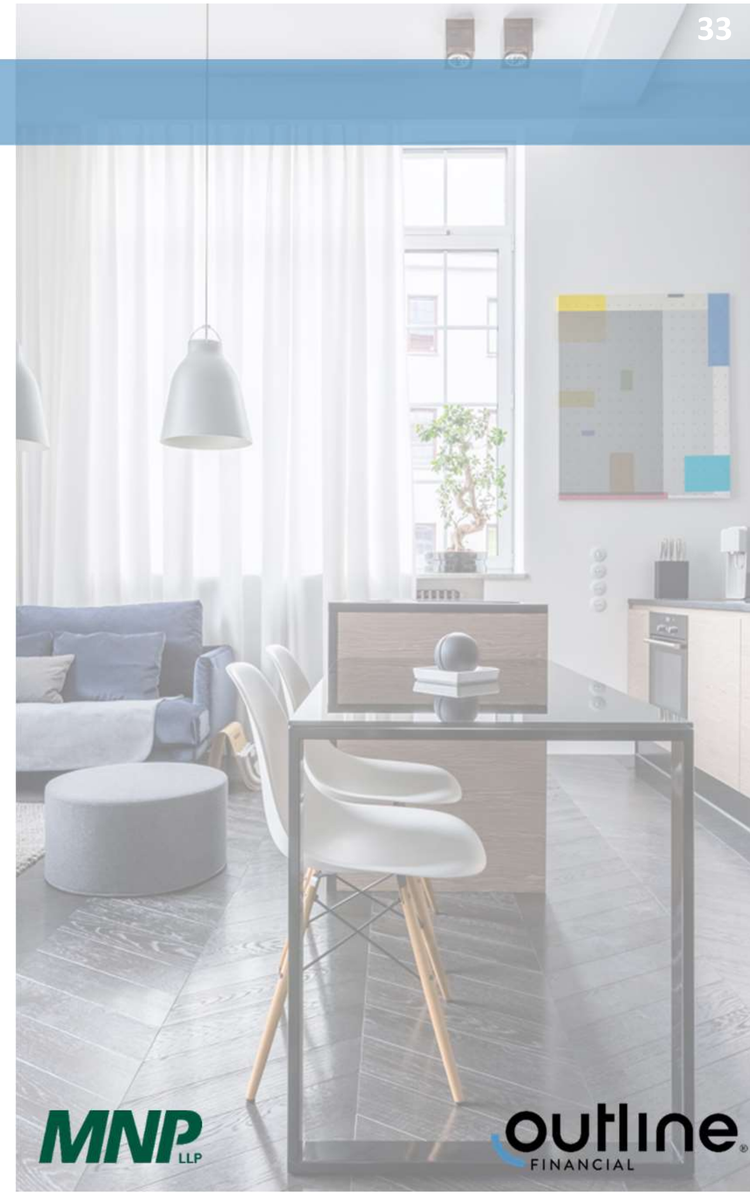
# How do I take title to an investment property

## What if I have a Professional Real Estate Corporation (PREC)?:

- The highest marginal personal tax rate in Ontario is 53.5%
- The average rate of tax paid on $150K of taxable income is 31%
- By contrast see the active business rates below for a corporation:

| Corporate rates (CCPC) (Ontario) | 2020 |
|---|---|
| **Active business income up to $500,000** | **12.2%** |
| Active business income above $500,000 | 26.5% |

- Retained funds tax at 12% (so 88% remaining) could be loaned over to a Holdco to buy real estate → Loan can be interest free in many cases



# Thank You!
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