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Memorandum

To: Real estate investors
From: George Dube
Date: October 3 2008
Re: Structuring real estate investment points for discussion

Keep in mind that this memo is general advice, in point form so many critical details are not included, current as of today, and should not be relied upon without consultation with your taxation advisor since it is only summary information.

While tax issues are certainly important in determining an appropriate methodology of structuring your real estate, a variety of non-tax considerations must also be considered. We evaluate your current situation and future goals in the following framework.

1. flexibility of choices,
2. legal issues,
3. taxation impact — short and long-term
4. financing perspectives,
5. investment and business considerations

Combining the advice or your tax, legal, financial and other real estate advisors is key, but unfortunately a frequently overlooked step which at times leads to regrettable decisions.

Overall we tend to like to see simple structures used in the beginning which are capable of allowing growth in the future.

Points of discussion include:

- Tax structure of real estate investments (including whether or not to incorporate)
- Coordinating different real estate activities from a tax/accounting/business perspective
- Use of property management companies
- Various methods of remunerating owners and their families
- Discussion of how different real estate transactions are taxed
- Tax and accounting implications to different financing scenarios

- Other financial considerations for real estate investing
- Discussion of the use of the "Smith Manoeuvre" with real estate investing
- Discussion of common tax myths related to real estate

Many of the above topics are intertwined with each other and organized on the basis of the structure of your holdings.

Structure

- **Personal ownership**

- Generally speaking, subject to legal concerns, in our mind this form of ownership is adequate if you have no intention of owning much real estate, i.e. only a couple of properties of low value. Ignoring legal issues, it's nice to start simple and ensure that additional real estate properties are really in your future.
- Income and losses directly affect your personal tax situation.
- Limitations on depreciation as you cannot create an overall loss.
- Principle residence exemption possibilities (but be cautious because this exemption is not available to the degree expected by many real estate investors and/or builders).
- Simple and cheaper (in the short-term) to operate.
- Can be expensive and a little bit of a hassle to transfer real estate subsequently to a corporation.

- **Partnership ownership**

- Generally taxed in a similar manner to sole proprietorship with some exceptions. More of the concerns typically come from the legal perspective.
- Tax filing requirements exist, and are increased slightly dependant on the number of partners. No more so than corporate filing requirements though.
- Benefit of "flow-through".

- **Limited partnership ownership**

- Losses may be restricted to "at-risk" amounts.
- Practical issues in terms of size and aggravation.
- Potential for separation of financing costs from ownership (therefore more depreciation).
- Image issue.
- Tax filing requirements exist although no more so than corporate filing requirements.
- Benefit of "flow-through".

- **Corporate ownership (often through a numbered company)**
 - Taxed much differently than an individual.
 - A variety of advantages and disadvantages.
 - Active (16.5% for profits less than \$400,000 in Ontario and decreasing – lower in BC (15.5%) and Alberta (14%)) vs. inactive income (48.67% initially but net of 23.12% after RDTOH) as compared to a maximum personal tax rate of 46.41% in Ontario (just over 30% at approximately \$37,000 of taxable income). However, with personal tax rates there is minimal if any tax on roughly the first \$15,000 of income. Further, when funds are taken out of the corporation, both personal and corporate taxes can be incurred when not planned correctly.
 - Potential of reducing provincial tax rates where properties are owned in lower tax rate provinces.
 - Setting up separate structure if your own business uses facilities.
 - Ability to better segregate personal and business activities, including possibly several businesses or different business arrangements.
 - Use of partnership for property management and conversion of inactive to active income or alternatively associated corporation.
 - Greater likelihood of soft costs being allowed.
 - May be more favourable vehicle treatment through the use of a corporation.
 - You may be able to acquire more property because debt is in the name of the corporation thus your personal credit and debt servicing ability are assisted in some cases where guarantees or related party debts are not considered. This may not be as relevant where the “110% rule” is applicable on the personal side. Discuss further with your financing advisor to see if applicable in your situation.
 - Potential for separation of financing costs from ownership (therefore more depreciation and potential deferral of taxes).
 - Potential tax deferral on bonuses.
 - More possibilities for financing of child’s (or grandchild’s) education.
 - Ease of change in ownership plus estate planning possibilities.
 - Potential conversion of “recapture” to a capital gain through sale of shares.
 - Ability to set up additional choices with financing plus use corporate financing, particularly through the use of a second corporation and inter-corporate dividends (i.e. it may open up some opportunities to acquire real estate you otherwise would have to pass on).

- Significant savings possible on financing where other business activities exist (and possible use of \$750,000 tax exemption).
- Ability to set personal remuneration policies and choices between salaries/bonuses and dividends – plus temporary draws. Thus providing more flexibility.
- Inability to deduct losses against personal income (but if you have sustained losses, why are you investing?).
- Potential ability to avoid land transfer tax where you sell corporate shares vs. the actual property.
- Potential creditor protection opportunities with appropriate structure involving corporations and/or trusts (Ensure that you consult with a lawyer about your own situation. Also note that many lawyers believe that corporations do not provide significant additional protection.). Why put all your assets at increased risk?
- Significant difference in probate fees if you are concerned about eventual probate fees paid by an estate (first from share ownership, second from netting mortgages and property value).
- Roughly costs an extra \$1,000 per year in professional fees compared to a proprietorship or partnership owning 3 properties. Thus make sure that there is a beneficial reason to have a company(ies). On the other hand, where you have real estate of \$1,000,000, the additional professional fees, which are tax deductible, represent 1/10 of 1 percent of the asset value. A very small premium particularly when compared to standard management expense ratios for mutual funds for example. That being said, still, \$1,000 is \$1,000.
- Potential double taxation, although it can be avoided if you plan properly.
- **Other ownership**
 - Examples include joint ventures, trusts, and foreign ownership. Joint ventures and trusts are becoming more popular again. When creating joint ventures, there are separate accounting issues and there is a huge issue of ensuring that you have a joint venture as compared to a partnership. Trusts are more often used for creditor protection reasons or ensuring those who currently or in the future may not be able to look after themselves are taken care of to the degree possible.
- **Use of internal management and “siphon” companies**
 - There are more ways to save taxes, make additional investments and help protect your assets, however, there has to be a need and benefit dependant on the size of your portfolio.

Some issues to consider

- **Don't get caught up in the excitement.** While having a complex structure including multiple companies and trusts may be beneficial to various investors, it can be disastrous to other investors. Yes, we are strongly in favour of using corporations in many cases, but we recognize that a significant number of cases exist where a corporation is completely inappropriate. When in doubt, go slow and be comfortable with your structure before expanding. Find an advisor you can truly trust to look after your best interests and feel free to question them on why they are advising a particular structure over another. While we personally believe that most advisors do have your best interests at heart, we cannot deny that exceptions exist.
- **Interest deductibility.** It's not as easy as some people would like you to believe. Ensure that you set up your structure correctly and keep it that way. Note that the government is looking at making some changes to the deductibility rules again. (Mind you I have had this particular note in my presentation for a number of years now – and it is still applicable)
- **Income vs. capital.** There is a difference in taxation for the majority of those in the business of earning rental income vs. gains from selling property. Issues of intention, secondary intention, feasibility, use of borrowed money, length of time held, reasons for sale, history, and so on. Consider the use of two companies where one holds long-term investments and the other holds those that will be sold in the short or medium-term. Careful documentation can be a large tax saving requirement.
- **Development of real estate.** Various rules are specific to this area and should be discussed with your tax advisor.
- **Personal or living expenses.** Careful consideration is required where you use a portion of a rental property yourself or other relatives do. For example, potential denial of losses or potential loss of principal residence exemption.
- **Related investments.** Some don't want to directly own real estate but would like to indirectly invest. Consider loaning funds to someone else or invest with others so that you do not have to do all of the work needed. You have a variety of ways to set up from a tax and investment perspective.
- **Creditor protection.** If you believe that this is an issue for you, discuss with your lawyer and tax advisor the legal and tax implications of different creditor protection plans. Included amongst the topics of discussion should be leverage, security on your family's personal or corporate loans, and the use of family trust(s).
- **Use of property management companies.** There can be some significant tax (ex. conversion of income, multiplication of small business deduction), financing (2nd company, subleasing, (which may negate some tax advantages)), marketing (comprehensive advertising for all your properties, image), estate planning (ease

and minimal business risks of bringing next generation into structure – training next generation) and business advantages (business relationship with tenants vs. owner relationship) to the use of your family's own property management companies depending on your situation. Further, there may be some legal advantages that should be discussed with your lawyer. On the other hand, this may add excess complexity and cost that is not beneficial for your situation.

- **Consider other financial issues.** Many real estate investors ignore issues such as life insurance (both from a protection and investment perspective) and non-real estate investments. A sharp difference exists between the insurance your financial institution offers and that which an insurance/investment advisor typically provides. Ensure you understand the conceptual differences before choosing the insurance provided by the financial institution. Non-real estate investments can be quite advantageous as well in securing other real estate investments. Discussions with your investment/insurance advisor are important here, as they affect the future of you and your family.
- **Use of "Smith Manoeuvre" with real estate investing.** This can be done in different ways but watch your cash flow. The information in the book, while accurate, in my opinion doesn't focus sufficiently on the scenarios for highly leveraged individuals on the source of the cash flow to make additional interest payments (and the tax implications of this). Nor, given perhaps the time it was written, does it give realistic examples of possible savings today due to the interest rates they chose in the demonstrations. That being said, I believe it is worthwhile to discuss the book with your investment advisor and accountant.

Common tax myths

Actually there are many, but I will just begin by listing the larger myths.

1. **Don't incorporate.** While not everyone should incorporate, the vast majority of serious investors should in our minds, although not necessarily for tax reasons. Many of these reasons are outlined above but again are not applicable to all.
2. **If you sell a property, you will get a capital gain for tax purposes.** While this may be true, many real estate investors will be taxed as if this were normal income for their business. If there is a possibility for a capital gain, there is also the possibility for "recapture."
3. **Don't take CCA (tax equivalent of depreciation) on your properties.** With the exception of properties that may qualify for your "principle residence exemption," this is almost always a poor financial decision in our minds. Why pay taxes now when they can be deferred, potentially indefinitely?

Why listen to George and his team?

- George is a chartered accountant with over 15 years of experience. He has a master's degree in accounting that specialized in taxation.
- George's family owns a small portfolio of real estate.
- Real estate investors are the largest portion of our accounting practice. George relies heavily on a qualified team to assist our clients.
- We have seen through various clients (including other accounting firms which use George's tax advice), training with respected organizations, as well as his own activities, many effective tax and business techniques related to real estate. Similarly we have seen many poor ways of doing things. Learn from experience, not the hard way.

We offer a free no obligation initial consultation to potential customers during which we can discuss your specific situation and questions. Your referrals and business are greatly appreciated and desired for our expanding firm.

George E. Dube, CA