

Chapter 7 - Common Real Estate Expenses

"Taxes are the price we pay for a civilized society."
Oliver Wendell Holmes Jr., Supreme Court Justice
1841-1935

Before discussing specific rules, it's useful to start with the general rule for deducting expenses.

General deductibility rule

Per the Canadian Income Tax Act (ITA), section 18 (1), "In computing the income of a taxpayer from a business or property, no deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."

While this sets out the general rule that any outlay or expense incurred for the purpose of earning income is tax deductible, like all general rules, it's subject to being overridden by a specific rule. One such rule is ITA section 18(1)(l)(i), which denies the deductibility of, among other things, golf course memberships regardless of the usage of the golf course.

Specific Deductions

Advertising

Any advertising cost incurred for the purpose of renting out the property is deductible. That includes all the online ad costs, "for rent" signs you purchased or specifically made for your property, and so on.

Auto expenses

Different criteria apply if you own one property versus when you own more than one property.

For investors who only own one property, you're only allowed to deduct motor vehicle expenses if:

- o The rental property is in the same general area that you live in
- o You do repairs and maintenance for your property and
- o You have vehicle expenses to transfer tools and materials to the property.

But you can't deduct the expenses you incur for the purpose of collecting rent if you have only one property.

For investors who own more than one rental property, in addition to the expenses mentioned above, you can also deduct the auto expenses incurred for the following reasons:

- o Collecting rents
- o Supervising repairs
- o Generally managing the properties

To qualify for the multiple properties criteria, you must have at least two different rental locations other than your principal residence. That means that if you rent out the basement of your principal residence and have one single-family detached home as a rental property, you still can't deduct any expenses incurred for collection of rent, supervision of repairs, and general management of the properties.

Capital cost allowance (CCA)

CCA is the tax term CRA uses to represent the depreciation or wear and tear on enduring assets such as a building. It allows you to defer a portion of the income on your property until the year you sell it. When you sell your property, all the

CCA deductions taken throughout the year must be reported as regular income, provided you have a gain on the sale of the property. This is referred to as recapture income. Generally, if the rental property was or is your principal residence, it's advisable not to claim CCA so you preserve 100% of your principal residence exemption for the maximum period allowed.

CCA, as previously discussed, is the tax term for depreciation or wear and tear on assets. This deduction is often overlooked by taxpayers and can be a substantial amount especially if your property is located in a high growth area.

Different rates CCA apply to different asset classes. Here are some of the common classes that apply to real estate investors: (the chart is available in the book)

Accelerated investment incentive property (AIIP) is a property (other than property included in class 54 or 55) that meets the following conditions:

- you acquired it after November 20, 2018 and it becomes available for use before 2028
- no CCA deduction or terminal loss has been claimed on the property before you acquired it, if the property was acquired from a non-arm's length party or on a tax-deferred roll-over

Accelerated Investment Incentive will provide an enhanced first-year allowance for certain eligible property that is subject to the Capital Cost Allowance (CCA) rules. In general, the incentive will be made up of two elements:

- applying the prescribed CCA rate for a class to up to one-and-a-half times the net addition to the class for the year
- suspending the existing CCA half-year rule (and equivalent rules for Canadian vessels and class 13 property)

Available for use – generally, the earlier of:

- the time the property is first used by the claimant to earn income

- the time the property is delivered or is made available to the claimant and is capable of producing a saleable product or service

As previously mentioned, when you sell your property, all the CCA deductions taken throughout the year must be reported as regular income, provided you have a gain on the sale of the property. This is referred to as recapture income and will be fully taxable as regular income.

I have a client who over the years purchased five investment condos in the Vancouver area. Because of the strong increase in Vancouver property values, when he sells the condo's one by one, he's paying tax on the recapture at a higher tax rate than he deducted the CCA at originally, albeit he has the funds on hand to pay the recapture tax.

If you're in a situation where you anticipate selling your investment property in the near future and you anticipate having a substantial capital gain on the property, it may make sense to not claim any CCA at all to avoid having this problem.

When purchasing a building, it is important to have the purchase price allocated to the various classes of assets such as building, furniture and fixtures etc. a process called cost segregation. For more expensive purchases such as for a large apartment building, a formal engineering study will need to be undertaken to justify the allocation of the costs.

The whole purpose of this is to write off as much as possible as quickly as possible which reduces the amount of taxes you pay while you operate the building.

Note that you are required to allocate the purchase price of a property between land (not depreciable) and building (depreciable). CRA will tell you to use the allocation specified in the purchase documents. The only trouble with that suggestion is that in over thirty years of practice, I have never seen such a breakdown in the purchase agreement. They will also suggest you use the values assessed for property tax purposes but these values aren't considered to be a true reflection of the current fair market value of the land and building.

So, how do you determine the price split between the two? You have to use an estimate. I typically use an 80:20 ratio in favour of the cost of the home if it isn't a condo apartment and 95:5 ratio if it is. Note that even in the case of a condo apartment, there is some land purchased as fractional ownership of the common areas is considered land.

Financing charges

Financing charges are usually one of the most missed deductions for real estate investors. Some real estate investors incur mortgage insurance expense or finder fees (secondary lenders charge fees) for their mortgages. These expenses are deductible over the length of the mortgage, which is typically a period of five years.

Home office expenses

You can deduct home office expenses for your real estate rental business—like cell phone and Internet charges, which aren't pro-rated, and things like rent or mortgage interest, insurance, property taxes, repairs, and utilities, all of which are pro-rated, typically as a ratio of the square footage of your office to the total square footage of your home. Check with your accountant to ensure that this claim won't unexpectedly affect your principal residence exemption.

Insurance

Insurance coverage for rental properties is required to protect yourself against significant losses such as from a fire, flood, or severe vandalism.

Line of credit (LOC) interest

Many real estate investors start by refinancing their homes to obtain the down payment for their real estate investment. The interest on such a loan is tax deductible. Be sure to track the usage of your LOC carefully, and ideally, only use it for your rental property, as CRA will often deny the LOC interest deduction if the

funds can't be clearly identified as to business and personal use of the LOC. It's far better to keep the funds separated than to co-mingle them.

Mortgage interest (not the mortgage principal)

Mortgage payments consist of mortgage interest and principal payments. Mortgage interest is a deductible expense, but principal payments aren't. The breakdown between the two can usually be found on the annual mortgage statement you receive at the beginning of the following year.

Professional fees

Fees paid to prepare your tax return are typically deductible.

Property management fees/commission you paid

These are deductible expenses if you hire a property manager or use a realtor to find a tenant. Make sure you get the invoice from them to support your expense claim.

Property taxes and utilities

Municipal property taxes and utilities are generally deductible against rental income. Two of the most missed deductions are property tax and utilities in the year of purchase or sale. Lawyers typically list these adjustments in a document called "Statement of Adjustments." Have your accountant review these carefully to ensure all valid expenses accounted for in the booking of the purchase or sale.

Repairs and maintenance

Repairs and maintenance are generally deductible expenses. The tricky part is determining whether an expense incurred should be capitalized and written off over time or expensed immediately.

Generally, an expenditure for the maintenance or repair of a property is a **current expense** that is deductible in the period. Some of the elements of a current expense are:

- It is a recurring expense for the replacement or renewal of a specific item
- The useful life of the acquired property is relatively short (generally does not exceed a year) and provides little long-term benefit
- It repairs, maintains or restores an asset to its condition when originally acquired by the taxpayer.

Generally, a **capital expenditure** is made to acquire or improve depreciable or non-depreciable capital property. Some of the elements of a capital expense are:

- It provides a lasting or enduring benefit
- It improves or enhances the property beyond its original condition
- A separate asset is acquired
- The amount of the expenditure is high in relation to the value of the whole property or in relation to previous average maintenance and repair costs
- The costs are incurred to repair property acquired so that it is in a suitable condition for use
- The repairs were made in anticipation of the sale of the asset.

Training

Real estate courses or meetings may be deductible depending on your circumstances.

The fix-and-flip

Many of the above expenses are also deductible to real estate investors who buy homes to repair and resell, often called the flip method. In addition, some expenses (usually considered capital expenses to be added to your home's cost base and deducted from your home's sales price) are immediately deductible since this is a fix-and-flip business. These expenses include:

- Broker's fees
- Commissions
- Land transfer taxes, where applicable
- Legal fees and other acquisition costs, and disposition costs like mortgage termination charges
- Renovations/improvements (e.g., deck or new roof)
- Title insurance.