TAXING TIMES

An increasing number of real estate investors are managing their holdings under a corporation structure. In part one of a special series on tax issues, Marshall Haughey outlines the key elements investors need to know about this setup

A corporation is an extremely common vehicle through which to carry on business or hold investments. There are numerous advantages and disadvantages of holding real estate through a corporation, but as every investor's financial status is different, it is ultimately up to the individual to decide what makes the most sense for their particular situation.

LEGAL ISSUES

Legally, a corporation is a person separate and distinct from its shareholders. Two important consequences flow from this legal fiction:

1. A corporation is able to own property

2. The shareholders of the corporation are not liable for the debts or other liabilities of the corporation.

Limited liability means that you, as a shareholder, are isolated from the liability associated with the actions of the corporation. However, the benefits of limited shareholder liability are at least somewhat reduced where a private corporation is used to hold real estate investments. One practical reason is that lenders will still generally require you to be personally liable for any loans given to your corporation. Most real estate investors will need a mortgage in order to purchase an investment property (a mortgage is usually advisable since financial leverage is what leads to superior returns on investment).

SETTING-UP

A new corporation will have no credit history, no financial statements, and little to no assets. Therefore, because banks like to reduce their risk as much as possible, they will require you to sign the mortgage personally (or at least co-sign or guarantee the mortgage). Similarly, any unsecured lines of credit or other loans will require you to be personally liable in the event of default on the loan.

This may no longer be the case once the business has become successful and has accumulated assets and a track record of cash flow to give the bank enough confidence to make loans without a personal guarantee.

Another way you can be liable is if you personally commit a tort (a legal term that essentially means a wrongful act) when you are acting on behalf of the corporation as its employee or agent. Since many real estate investors manage their own properties, there is the potential to commit a tort. There are many different kinds of torts, the most common of which is the tort of negligence.

For example, if you are negligent and do not take proper care in carrying out repairs on your property and tenants or their guests are injured as a result, you may be personally liable notwithstanding that the property is owned and managed by the corporation. It is important to keep in mind that you are liable for torts you commit whether you operate as a sole proprietor, through a corporation, or an alternative structure such as a limited partnership. In short, the reader should be aware that simply incorporating a corporation does not relieve you of personal liability for all actions undertaken on behalf of the corporation.

Notwithstanding the limitations outlined above, the corporation still offers a shareholder limited liability that is not available where the individual holds the investment property personally. Nevertheless, a similar level of protection from liability is available through alternative structures.

COUNTING THE LOSSES

In the event that you sustain losses on your investment, you will be unable to use those losses to offset income earned outside the corporation.

This is not a concern where you hold multiple properties in a corporation and one of them sustains losses while the others are profitable. In that situation, you can generally apply the losses from the one property to reduce the income received from the other profitable properties.

However, if you hold only one property in the corporation and it sustains losses, or you hold multiple properties and the losses from the one property exceed the profits from other properties, you cannot apply those losses against your other sources of income such as employment income or income from other investments not held by the corporation.

INCOME TAX

Income tax legislation distinguishes between active and passive income and taxes each type of income differently in the hands of certain corporations. For Canadian-controlled private corporations (CCPCs), it is disadvantageous to earn passive investment income. CCPCs are generally taxed at rates as high or higher than the highest individual tax rates on passive investment income.

The reason for this is that the Canadian government does not want individual investors to incorporate companies to hold their passive investments such as stocks, bonds, and real estate to take advantage of corporate tax rates that are lower than tax rates for individuals.

Being able to defer income in this manner is what is called a deferral advantage (or deferral disadvantage) as it may leave more (or less) income in the corporation than if the individual held the investments personally.

What the Income Tax Act (ITA) essentially does for CCPCs that earn investment income is charge the standard corporate tax rate plus an additional refundable tax. This refundable tax is, as the name suggests, refunded to the corporation once the corporation pays out its earnings as dividends to its shareholders.

The table below demonstrates the difference between earning investment

INVESTMENT INCOME KEPT IN CORPORATION VS. HOLDING INVESTMENTS PERSONALLY (BEGINNING IN 2014)

Province	B.C.	AB	SK	MB	ON	QC	NB	NS	PEI	NL	YT	NWT	NT
Combined federal/provincial corporate tax rate (%)	45.7	44.7	46.7	46.7	46.2	46.6	46.7	50.7	50.7	48.7	49.7	46.2	46.7
Combined federal/ provincial personal tax rate in highest tax bracket (%)	43.7	39.0	44.0	46.4	49.5	50.0	45.1	50.0	47.4	42.3	42.4	43.1	40.5
Difference	+2.0	+5.7	+2.7	+0.3	-3.3	-3.4	+1.6	+0.7	+3.3	+6.4	+7.3	+3.1	+6.2

income in a corporation (before paying out dividends and getting back the refundable tax) and earning that income personally in each province and territory.

MONEY MATTERS

As the table above demonstrates, in every province and territory (other than Ontario and Quebec), there is a deferral disadvantage to receiving passive income in your corporation rather than personally. So, for example, an Albertan real estate investor would have an additional $57 for every $1,000 of income to invest back in his or her business or pay off debt by receiving that rental income personally rather than through a CCPC.

The next problem is that, at some point, you may want to get the income out of the corporation and into your hands as the shareholder. When corporations pay out their earnings to shareholders, it is accomplished through paying dividends. Once dividends are paid, the refundable tax mentioned above is refunded to the corporation.

However, the shareholder will now have to pay tax on the dividend. What the government tries to do is create a system where the tax result will be the same whether the passive income is earned through a corporation and paid out as dividends to its shareholder or the individual earns the passive income directly. This system is called integration.

Integration involves grossing up the dividends and deducting dividend tax credits so that, when the amount of tax paid by the individual on the dividends is added to the tax paid by the corporation, it will roughly equal the amount of tax the individual would have paid if they had earned the income personally. Integration is nice in theory, but the reality is that it does not work out perfectly. The result is usually a larger tax bill by earning passive income through a CCPC.

Due to some changes the federal government introduced in its 2013 budget, dividends paid by CCPCs from passive income will be taxed even more unfavourably beginning in 2014. By reducing the federal dividend tax credit, the amount of federal tax paid on these dividends will go up

> Dividends paid by CCPCs from passive income will be taxed even more unfavourably beginning in 2014

INVESTMENT INCOME EARNED IN CORPORATION AND PAID OUT AS DIVIDENDS VS. HOLDING INVESTMENTS PERSONALLY (BEGINNING IN 2014)

Province	BC	AB	SK	MB	ON[2]	QUE	NB	NS[3]	PEI	NL	YT	NWT	NT
Combined corporate income tax and personal tax on dividends1 (%)	49.8	42.5	48.3	52.6	50.6	51.9	48.8	53.7	54.4	46.2	47.7	44.2	45.0
Combined federal/ provincial personal tax rate in highest tax bracket (%)	43.7	39.0	44.0	46.4	49.5	50.0	45.1	50.0	47.4	42.3	42.4	43.1	40.5
Difference	+6.1	+3.5	+4.3	+6.2	+1.1	+1.9	+3.7	+3.7	+7.0	+3.9	+5.3	+1.1	+4.5

1. Assuming the shareholder receiving the dividends is in the highest marginal tax bracket.
2. Ontario's highest tax bracket is for income in excess of $509,000 for 2013 which is much higher than the highest federal bracket.
3. Nova Scotia's highest tax bracket is for income in excess of $150,000 which is higher than the highest federal bracket.

Jurisdiction	Additional Tax Paid	5 Years	Lost Profit at 5 Years	10 Years	Lost Profit at 10 Years	20 Years	Lost Profit at 20 Years	30 Years	Lost Profit at 30 Years
Base Case (12% annual return)	0%	$17,623	$-	$ 1,058	$ -	$96,463	$ -	$ 299,599	$ -
BC	6.1%	$13,319	$(4,304)	$ 7,740	$(13,318)	$31,472	$(64,991)	$ 55,831	$ (243,768)
AB	3.5%	$15,037	$ (2,587)	$22,610	$(8,449)	$51,120	$(45,342)	$ 115,583	$ (184,017)
SK	4.3%	$14,490	$(3,133)	$20,997	$(10,061)	$44,087	$(52,376)	$ 92,570	$ (207,029)
MB	6.2%	$13,256	$(4,367)	$17,573	$(13,485)	$30,883	$(65,580)	$ 54,271	$ (245,328)
ON	1.1%	$16,775	$ (849)	$28,139	$(2,919)	$79,183	$(17,280)	$ 222,816	$ (76,783)
QUE	1.8%	$16,252	$(1,371)	$26,413	$(4,646)	$69,764	$(26,699)	$ 184,267	$ (115,332)
NB	5.5%	$13,701	$(3,923)	$18,771	$(12,287)	$35,236	$(61,226)	$ 66,144	$ (233,456)
NS	3.7%	$14,898	$(2,725)	$22,197	$(8,862)	$49,268	$(47,194)	$ 109,359	$ (190,240)
PEI	7.0%	$12,763	$(4,861)	$16,289	$(14,770)	$26,533	$(69,930)	$ 43,219	$ (256,380)
NL	3.9%	$14,761	$(2,862)	$21,790	$(9,268)	$47,480	$(48,983)	$ 103,460	$ (196,140)
YT	5.3%	$13,830	$(3,793)	$19,127	$(11,932)	$36,584	$(59,879)	$ 69,973	$ (229,626)
NWT	1.1%	$16,775	$ (849)	$28,139	$(2,919)	$79,183	$(17,280)	$ 222,816	$ (76,783)
NT	4.5%	$14,356	$(3,267)	$20,610	$(10,448)	$42,479	$(53,984)	$ 87,550	$ (212,050)
Difference	+2.0	+5.7	+2.7	+0.3	-3.3	-3.4	+1.6	+0.7	+3.3

another 1.6 per cent. Also, provincial taxes on dividends are generally computed by reference to federal tax rates which means there will be an increase in the provincial taxes owing as well.

For example, an Alberta resident who owns real estate investments in a CCPC will end up paying 42.5 per cent in corporate and personal taxes in 2014 after the rental income is paid out as dividends. This is an additional 3.5 per cent of tax than if the individual had held the real estate personally and paid the top combined marginal rate of 39 per cent.

Paying an additional 3.5 per cent in tax may not sound like much, but it will have a serious impact on the performance of your investment over the long run. To illustrate this impact, consider the table above. The table compares the base case, where a real estate investment owned personally provides an annual return of 12 per cent, against earning that 12 per cent return minus the additional tax paid in each of the provinces and territories.

As you can see, the additional tax paid would have a significant adverse effect on the performance of your investment, even within the first five years. This table only considers the return on a $10,000 investment. Where larger amounts are invested, the lost profit would be proportionately higher.

It is not difficult to see that there is the potential to miss out on hundreds of thousands if not millions of dollars of profit over the long run simply by paying a few per cent more tax year after year. The additional tax cost of incorporation is a powerful incentive to find an alternative structure through which to hold your real estate portfolio.

In conclusion, the benefits of holding real estate through a corporation are considerably offset by the negative tax treatment associated with the structure. However, there are alternative structures to incorporation, which will produce more favorable tax results while at the same time offering a number of other benefits to the real estate investor. ■

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