Taxing times: ALTERNATIVE ROUTES TO INCORPORATION

While managing a real estate portfolio under a corporate structure can sometimes create tax burdens, there are other options. In part two of a special series on tax issues, *Marshall Haughey* explores some of the alternatives to incorporation

Last month, I demonstrated why holding real estate investments through a corporation may not be advisable from a tax perspective. In this article, I explore two popular alternatives to incorporation that investors should explore.

HOLDING PERSONALLY

✔ ADVANTAGES

Simplicity. Holding real estate, either personally or as a co-owner with one or more others, is much simpler than using a corporation, while also saving you money on legal and accounting fees. That being said, it is still advisable to consult a lawyer to make sure you have a proper co-ownership agreement in place when you buy real estate with one or more other parties.

Lowest possible tax rate. By holding real estate personally, you pay tax at your personal marginal rate depending on which tax bracket you fall into. This is a significant advantage over receiving rental income through a corporation which was discussed in Part 1.

✘ DISADVANTAGES

Full liability. The main drawback to holding real estate personally is that you have full exposure to liability if anything goes wrong. However, this liability can be managed through the use of liability insurance. It is crucial to make sure you have an adequate amount of liability insurance to guarantee you are protected in case the unexpected happens. As a prudent real estate investor, you will undoubtedly have fire insurance to protect your property. Make sure to tack on an appropriate amount of liability coverage to that policy.

LIMITED PARTNERSHIP

A partnership is defined at law to be two or more persons carrying on business in common with a view to profit. This is the definition of a "regular" partnership. One significant drawback with a regular partnership is that each partner is personally liable for the acts of the other partners. Fortunately, provincial legislation provides a more useful vehicle called the limited partnership. The limited partnership has two kinds of partners: general partners and limited partners. The general partners manage the business and have full liability. The limited partners' liability, as the name suggests, is limited to the amount invested in the partnership (similar to shareholders of a corporation).

A limited partnership used in the real estate investment context would generally be structured in the following manner. A shell corporation is incorporated to become the general partner in the limited partnership and would be tasked with managing the business of the limited partnership (i.e. managing the properties).

The individual real estate investors will be the limited partners. The individuals actually performing the management of the property (usually one or more limited partners) will be directors and officers of the corporate general partner. That way, these individuals can manage the properties (i.e. control the business), but they are doing it on behalf of the general partner (the shell corporation) and not in their capacity as limited partners.

ADVANTAGES

Flow-through tax treatment. Unlike a corporation, a partnership is not a legal entity taxed separately from its partners. Rather, the partnership income is calculated and each partner claims their proportionate share of the income on their tax return. This means that the limited partners are taxed in the same manner as if they held the investments personally, and will pay tax at the rate in the tax bracket they happen to be in. Flow-through taxation also means that in the event the partnership sustains any losses, the partners can apply those losses against their income from other sources to reduce their tax bill.

Limited liability. Only the general partner is exposed to unlimited liability. Since the general partner will be a shell corporation (i.e. a corporation with no assets) this should insulate the limited partners (i.e. you and the other investors) from risk.

DISADVANTAGES

Additional administrative expenses. There are additional costs to the limited partnership structure that you would not encounter if you hold your investments personally, such as legal fees to set up the structure and additional accounting expenses to prepare partnership and corporate tax returns.

TRUST

Like a partnership, a trust is a relationship between persons and not a separate legal entity. A trust is an arrangement whereby one person (called the settlor) transfers property to another person (called the trustee) for the benefit of a third person (called the beneficiary). There can be more than one trustee or beneficiary and the trustee can also be a beneficiary under the trust. The trustee manages the trust property and makes distributions to the beneficiaries in accordance with the terms of the trust deed.

ADVANTAGES

Quasi-flow-through taxation. Although a trust is not considered to be a separate person at law, the Income Tax Act pretends that the trust is an individual. A trust is therefore taxed as an individual at the highest individual tax bracket. However, a trust is only taxed on amounts of income that it does not pay out to its beneficiaries. This means that, provided the trust pays all of its income out to the beneficiaries (i.e. the investors), the trust will pay no income tax. The distributions made to the beneficiaries are included in the beneficiaries' income and tax is paid at the marginal rate depending upon the tax bracket the individual beneficiary falls into.

Therefore, a trust presents an opportunity to flow income through to the beneficiaries, which means that the least amount of tax possible will be paid on income from rental properties. The reason I refer to the call taxation of trusts as "quasi-flow-through" is because though income can be flowed through to the beneficiaries, losses cannot be. Thus, in the event the real estate investment sustains losses, those losses cannot be used by a beneficiary to offset other income and reduce his or her tax bill. This is a limitation that is not present when rental properties are held personally or through a limited partnership. However, trust losses can be carried forward to future years to be used against future income.

Limited liability for beneficiaries. Beneficiaries are generally not liable for the actions of the trustee. There is an exception to this rule where the beneficiaries are found to control the trustee.

DID YOU KNOW?

Deemed disposition every 21 years. A quirky rule under the Income Tax Act is that there is a deemed disposition of trust property every 21 years.

This means that at the 21-year mark, the trust is deemed to have sold and reacquired any property held by it.

So for example, if a building was purchased for $200,000 and it is worth $500,000 at the 21-year mark, the trust is deemed to have sold the building for $500,000 causing a $300,000 capital gain which the trust will now have to pay tax on.

There are ways to get around the 21-year deemed disposition rule such as rolling the property out of the trust before that time arises, but it can be a bit of an inconvenience.

DISADVANTAGES

Tax left in trust paid at highest marginal rate. If a beneficiary is not in the highest tax bracket, unnecessary tax is paid when any income is left in the trust. It is therefore important that the investor or their tax professional is diligent in ensuring all the trust's income is paid out to the beneficiaries in the year.

THE BIG DECISION

There are alternatives to holding your rental properties in a corporation that produce better tax results while still limiting your personal liability. The limited partnership accomplishes these outcomes particularly well, hence why it is so popular among sophisticated real estate investors.

For those considering purchasing investment real estate through a corporation, it is definitely worth considering using an alternative structure. For those who already hold real estate through a corporation, contact your legal and tax professionals to see if there is a tax-efficient way to get your investments out. Remember, the best legal structure will maximize and protect your wealth by

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