BESPOKE RENT-TO-OWN

Tax specialist **Andrew Ku** explains how a little thoughtful tailoring can optimize your next rent-to-own transaction

While my lovely wife and I were cleaning out our closets, Marie Kondo style, she asked if I needed to have some bespoke suits made, as I seem to have 'outgrown' my current ones. (I did not grow taller, unfortunately.) Custom-made goods of all kinds can be flattering, high-quality, lasting investments. In real estate investing, a rent-to-own arrangement can be the equivalent of a tailored suit when it comes to financial and tax planning.

A typical RTO has three elements: the sale of an option to purchase a property, a lease, and an installment sale of the property, which involves a series of deposit payments over the term of the agreement. As you can imagine, there are many dynamic parts, and the terms can get complicated. Tax treatments of such transactions are typically dictated by the legal aspects and the economic substance of the agreement.

Let's examine some common RTO transaction components and see how they impact the seller/ landlord in terms of taxable income:

1 Sale of option to purchase

An option (in this case, a call option) typically refers to a contractual arrangement between a seller and a buyer where the seller provides a right, but not an obligation, to purchase a subject property at a predetermined price within a predetermined timeframe. The value of such an option is usually a function of various factors, including the duration of the contract and the contractual purchase price of the subject property (determined by the estimated fair market value of the property at the time when the option can be exercised).

Generally, non-refundable option premiums received from the seller in RTO transactions are treated as taxable income.

2 Rental payments

A typical RTO transaction involves the buyer renting from the seller for a predetermined period of time. Rental payments are taxable income for the seller/landlord.

3 Deposit payments

In addition to the rental payments, the seller typically requires deposit payments toward the purchase price of the property. Similar to many vendor financing transactions, the intention is to allow buyers to have sufficient time to come up with the deposits.

For sellers, non-refundable deposits are generally treated as taxable income, but the seller may be able to defer the recognition of taxable income on refundable deposits.

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4 Buyer exercises the option to purchase

When the buyer exercises the option to purchase the property at the end of the lease,

TWO WAYS TO STRUCTURE STEVE'S RTO TRANSACTION

		Plan A			Plan B		
	Purchase price of property in 2018	$500,000			$500,000		
	Sale price of property (i.e. exercise price of the option) in 2021	$550,000			$555,000		
	Option premium	$10,000			$5,000		
	Duration	2 years			2 years		
Year	Items	Cash received	Tax rate	After-tax amount	Cash received	Tax rate	After-tax amount
2019	Option premium	$10,000	45%	$5,500	$5,000	45%	$2,750
2019	Rental payments	$30,000	45%	$16,500	$30,000	45%	$16,500
2019	Deposits (non-refundable)	$20,000	45%	$11,000	$5,000	45%	$2,750
2019	Deposits (refundable)				$15,000		$15,000
2020	Rental payments	$30,000	45%	$16,500	$30,000	45%	$16,500
2020	Deposits (non-refundable)	$20,000	45%	$11,000	$5,000	45%	$2,750
2020	Deposits (refundable)				$15,000		$15,000
2021	Sale of property*	$510,000	25%	$7,500	$515,000	25%	$3,750
	Total	$620,000			$620,000		

Plan A vs Plan B	
Difference in after-tax cash flow ($)	$7,000
Difference in after-tax cash flow (%)	10.3%

Assumptions: *The above example is for illustration purposes only. All income is treated as business income. The property is personally held by Steve. His applicable tax rate will drop from 45% to 25% upon his retirement.*

Tax calculation for Plan A: *($550,000 sale price – $40,000 non-refundable deposits – $500,000 initial price) x (1 – 25%) = $7,500*

Tax calculation for Plan B: *(Proceeds of $555,000 – $40,000 deposits – $500,000 cost) = $15,000 - $11,250 tax [($555,000 sale price - $10,000 Non-refundable deposits - $500,000 Cost) x 25%] = $3,750.*

the sale proceeds. Deposit payments received but not previously recognized as income are treated as taxable income to the seller.

The tailor in action

Let's look at a sample scenario. Real estate investor Steve purchased a residential property in Ontario at the end of 2018 for $500,000. Steve expects the property value to increase to $550,000 by early 2021. He is also planning to retire that year.

Steve is working on an RTO transaction (Plan A) with Roger, the tenant-buyer, at the beginning of 2019. Steve's tax advisor has also given him a few suggestions as illustrated in Plan B, laid out in the chart above. Both Plan A and Plan B would result in the same amount of cash flow over the term of the RTO. Plan B, however, would generate $7,000 more in after-tax cash flow, which is about 10% more than Plan A. This is a result of the following:

- Converting $5,000 of the option premium into the purchase price, thus deferring cash inflow and taxable income to a period when Steve will be subject to a lower tax rate.
- Splitting $40,000 worth of non-refundable deposits into partially refundable and partially non-refundable segments. This allows Steve to defer tax on the refundable portion of deposits until the deposits are applied towards the purchase price in 2021.

As seen from the illustration, there are many factors that need to be taken into consideration in an RTO transaction. The sample is used to illustrate a number of these concepts, but there are many other considerations, such as ownership structure, tenant credit risks, time value of money, market risk and hedging position. As such, investors should work closely with their tax advisors and lawyers to customize the structure, terms and conditions of an agreement to align with their investment plans. As always, tax optimization is a result of long-term planning and patience.

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ANDREW KU is a licensed public accountant who lives and works in Toronto. Contact him at andrew.ku@realestatetaxes.ca.