# ASSIGNMENT: PROCEED WITH CAUTION

Investors in the pre-construction space regularly use assignments to secure impressive returns. But as accountant **Andrew Ku** explains, the tax implications of such transactions require serious consideration


Savvy real estate investors are continuously finding new ways to maximize their profits in the shortest period of time. In addition to the traditional purchase, sale and rental of real estate, many investors are trading real estate via assignment. Assignment is a concept most people have a general understanding of, but when it comes to specifics – especially where taxes come into play – I find it's an area of real estate investing that could use a little exploring.

Generally, the term 'assignment' in a real estate transaction refers to an original buyer (the assignor) of a property transferring his/her rights and obligations of the Contract of Purchase and Sale to a secondary buyer (the assignee) prior to the completion of the first transaction. Assignments are widely used in the pre-construction residential condo marketplace, where investors are not required to fund the entire purchase amount right off the bat. This provides a lower barrier to entry for investors to get into real estate, and those operating in hot markets can be in for a sweet windfall if they can find hungry buyers looking to get in on the ground floor of a new building.

To illustrate how assignments work – and, more importantly, how investors can profit from them – let's take a look at the following case study:

Toronto investor Wayne bought into a pre-construction condo development in the financial district for $500,000 in July 2015. The estimated completion date is mid-2020. In September 2015, Wayne's Realtor received an offer to assign Wayne's unit at a $5,000 profit. At that time, Wayne had already put down a 10% deposit ($50,000) with the developer.

Without taking into consideration transaction costs, Wayne could achieve a $5,000 profit from his $50,000 investment in only three months. Annualized on a non-compounding basis, the return can be translated to 40% per year. Arguably, by assigning the condo prior to its completion, Wayne can generate a higher return on investment than selling it after its completion.

> Because the sale of a new condo unit is generally taxable for GST/HST purposes, the assignment is also subject to GST/HST

## The tax consequences

If you're like Wayne, your first question was probably, "So, what's the catch?" Generally, there are two tax implications in such a transaction.

1 **GST/HST.** Generally, the application of GST and HST is based on two criteria.

## ESTIMATED VERSUS ACTUAL TAXES

| | Wayne's estimated taxes | Wayne's actual taxes | Bruce's actual taxes |
|---|---|---|---|
| Assignment price | $55,000 | $55,000 | 15,000 |
| Deposit paid | $50,000 | $50,000 | $10,000 |
| Margin | $5,000 | $5,000 | $5,000 |
| Considerations for the assignment (amount subject to HST) | | $55,000 | $15,000 |
| HST | | $6,327 | $1,726 |
| Proceeds on assignment | | $48,673 | $13,274 |
| Profit/(loss) | $5,000 | ($1,327) | $3,274 |
| Taxable capital gains | $2,500 | | |
| Business income/(loss) | | ($1,327) | $3,274 |
| Personal tax rate | 40% | 0% | 40% |
| Personal tax liability | $1,000 | ($531) | $1,310 |
| After-tax profit | $4,000 | ($796) | $1,965 |
| Return on investment | 8.0% | -1.6% | 19.6% |
| Deposit as a % of total consideration of assignment | | 90.9% | 66.7% |

***Assumptions:*** *Contract value of is inclusive of HST; proceeds include the total amount received by the assignor, including funds to replenish the assignor's deposit to builder; business losses can be utilized against other business income. Transaction costs (i.e. commission, assignment fees, legal fees, etc.) are not included in the above calculations. The above example is meant to illustrate certain tax principles and may or may not be applicable to readers' own tax circumstances.*

First, upon entering into an agreement with the condo developer, Wayne is considered to have acquired an interest in the condo unit. For GST/HST purposes, the assignment of the agreement is normally considered to be a sale of Wayne's interest in the new condo. Because the sale of a new condo unit is generally taxable for GST/HST purposes, the assignment is also subject to GST/HST.

In addition, because Wayne intended to assign the condo unit for profit rather than occupying it himself, that would make Wayne a builder for the purposes of GST/HST. As such, this assignment transaction is subject to GST/HST.

2 **Income tax application.** Generally, assignments of property contracts for profit are treated as business income. They are also considered as earned income for the purposes of calculating your RRSP contribution room.

Based on Wayne's estimate in the chart above, the $5,000 profit is treated as capital gains, and only half of the gain is subject to income tax. That's wishful thinking.

When looking at Wayne's actual tax implications, the assignment price of $55,000 is inclusive of the deposit paid to the builder, and the entire purchase price is assumed to include HST. Excluding HST, the actual proceeds were only $48,673, so Wayne actually suffers a loss on this transaction.

Wayne's best friend, Bruce, is assigning his unit as well. However, his unit cost less, and his deposit structure is very different – he only paid $10,000 as a deposit at the time of assignment. Assuming Bruce is making the same profit of $5,000, the total transaction price is $15,000. Taking out HST, the proceeds were $13,274. This would leave Bruce a healthy return of $3,274.

## Key takeaway

Like Wayne, a lot of investors might not be aware that assignments on pre-construction residential properties or on new or substantially renovated residential properties are subject to GST/HST. More importantly, the entire assignment value, including the funds meant to replenish those given as deposits to a builder by the assignor, are considered part of the assignment consideration, which is subject to GST/HST.

Depending on the amount of deposit included in the assignment consideration, this could have a huge impact on the assignor's profit. As in Wayne's and Bruce's cases above, the lower the deposit as a percentage of assignment value, the higher the return on investment. Another way to resolve Wayne's situation is to exclude GST/HST on the assignment value, which is subject to negotiation between assignor and assignee.

According to various unofficial sources, the Canada Revenue Agency regularly approaches condo builders to look for assignors and unreported transactions. Should the CRA discover unreported transactions, it could assess a penalty equivalent to 50% of the amount owed. Interest will also be applied to both the amount owed and the penalty itself – so you can run, but you can't hide.

Assignments can be lucrative, but only if you take into consideration the inevitable tax impact. Run the numbers by your tax advisor to maximize your profits. ■

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