RENOS AND TAXES

Diving headfirst into a renovation project before considering the tax implications could result in huge losses. Tax advisor **Andrew Ku** explains the potential cost for investors who operate on assumptions rather than facts

The tax implications of a renovation project don't get much play on real estate TV shows, but they're important to have a handle on if you want to optimize the ROI of your reno. Let's take a look at an investor – we'll call him Bob – who has just gone through a renovation project of his own. Bob's story helps illustrate some of the fundamental tax concepts that are applicable to renovation projects. (The facts and assumptions of Bob's story may or may not be applicable to your own situation, of course, so you should always seek professional advice on the tax implications of any reno project you're considering.)

The background

Bob is a handy real estate investor who is actively involved in renovation projects in the GTA. His projects typically take anywhere between five and 12 months from start to finish. The process includes:

- Purchasing a single-family dwelling and taking the title personally
- Renovating the property from top to bottom
- Replacing the appliances and updating the landscaping
- Staging it for sale

Bob has been actively renovating properties for the past five years, averaging two projects per year and profiting about $100,000 per project. Unfortunately, Bob's understanding of his tax situation is not as developed as his reno know-how. He is operating under two key misconceptions that could put him in serious financial, and even legal, jeopardy.

Bob is working under the assumption that profits from the sale of his renovated properties are treated as capital gains because the properties are considered capital assets. If that were the case, only 50% of the gains would be taxable. Bob also believes that GST/HST is not applicable on his properties.

The CRA's view

Based on the facts of Bob's case (i.e. intent, frequency of sale, length/duration of the property being held, etc.), his real estate renovation projects may be regarded by the

THE TAX IMPLICATIONS OF A RENO

Events	Bob's misconception	Tax auditor's view	Potential outcome with tax advisor's input
Purchase of single-family residence for $1 million	Non-issue	HST not applicable on purchase of resale residential property, as it is exempted from HST	HST not applicable on purchase of resale residential property, as it is exempted from HST
Property is renovated; total cost of reno is $300,000	Non-issue	As the property was substantially renovated, the finished product no longer qualifies as 'exempted supplies' and will be subject to HST	Perform a tax forecast for each possible option based on available facts and assumptions. It's possible to structure the project under a corporation and renovate to a standard less than what is considered to be a substantial renovation
Property is sold; net proceeds are $1.5 million	The gain on the sale ($200,000) is a capital gain	Since the HST should be included in the price, the proceeds for tax purposes are $1.327 million ($1.5 million divided by the Ontario HST rate of 1.13). Because Bob is in the business of renovating and flipping properties, the gain on the sale is considered business income	Since the property does not fit into the 'substantially renovated' definition, the sale of the property would be exempted from HST
Proceeds on sale	$1,500,000	$1,327,000	$1,500,000
HST liabilities on sale	N/A	$173,000	N/A
Gains	$200,000	$27,000	$200,000
Taxable income calculations	($1,500,000 – $1,000,000 – $300,000) x 50%	$1,327,000 – $1,000,000 – $300,000	$1,500,000 – $1,000,000 – $300,000
Taxable income	$100,000 (personal)	$27,000 (personal)	$200,000 (corporate)
Income tax rate	45% (personal)	45% (personal)	13.5% (corporate)
Immediate cash tax liability	$45,000	$12,150	$27,000
Profit after tax	$155,000	$14,850	$173,000

Key assumptions: *For the purpose of this illustration, we have ignored legal fees, land-transfer tax and HST paid on expenses. HST has to be included in the sale price. Personal tax rate is assumed at 45%; 2018 combined federal and Ontario corporate tax rate is eligible for the small business deduction of 13.5%. There will be a personal tax effect when the corporation distributes dividends to its shareholders. The above figures are rounded to the nearest thousands.*

Canada Revenue Agency as 'adventure in nature of trade,' and thus the profit he earns would be considered business income rather than capital gains. Furthermore, 'capital items' usually refers to assets that provide enduring benefits, such as rental properties. Bob's flipped properties could be regarded as inventory rather than capital assets, and thus the capital gains treatment would not be appropriate.

The CRA taxes 100% of business income; thus, 100% of Bob's profit would be included as taxable income in the year it is recognized. The tax rate applicable would be dependent on Bob's personal marginal tax rate in that given year.

In addition, the CRA could consider Bob's work to be 'substantial renovations.' If so, the sale of such properties would generally be subject to GST/HST. For a renovation to be considered 'substantial,' a minimum of 90% of the existing building must be removed or replaced. As Bob usually guts an entire house, his projects could be regarded as substantially renovated.

A better way

A tax advisor would go through all the facts and assumptions with Bob and present a situational analysis with tax forecast statements for each option that would outline the taxes payable and the pros and cons of each. Personally, I would suggest Bob consider the following two options:

INCOME TAX. It may make sense for Bob to incorporate a renovation company to carry out his projects. The main tax advantage is tax deferral of income, assuming the corporation qualifies for small business deductions. A second advantage is that Bob may be able to qualify for a lifetime capital gains exemption on the disposal of the company shares, assuming certain requirements are met. Currently, the exemption limit is upwards of $835,000. That means Bob might be able to sell shares of the corporation with a tax-free gain of up to $835,000.

GST/HST. Depending on the market conditions, it might be advisable for Bob not to renovate the properties to the extent that he normally would. Detailed documentation, including professionally designed floor plans and before/after photos of the renovation, could help build the case that the properties were not substantially renovated and thus not subject to GST/HST upon sale.

As you can see based on the chart above, the after-tax profit could be substantially maximized ($173,000 versus $14,850) if Bob gets input from his tax advisor. Death and taxes cannot be avoided, but the amount of taxes and the timing of your payments can be optimized based on your personal circumstances. Be sure to consult your tax advisor prior to any renovation project to ensure you get the absolute best outcome. ■

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