64. Excluding Real Estate From Passive Asset Taxation in Private Corporations

DESCRIPTION

The availability of affordable residential real estate has become a concern in many local communities and is now a priority for both our provincial and national governments. Likewise, small business owners rely on the availability of commercial real estate, which has increased in value in many of our communities. An opportunity exists for the federal government to support private corporation investment in both commercial and residential real estate rental projects. However, the opposite has happened. The Income Tax Act (“ITA”) deems income earned from the rental of real estate to be “income from property” or “passive income” rather than business income, subjecting it to a different tax treatment that may create a disincentive for investments in real estate assets that can contribute to housing solutions and economic growth.

BACKGROUND

Income earned from the rental of real estate (“rental incoe”) is generally deemed “passive” under the ITA unless it meets certain criteria to be “active business income”. Active real estate assets or “active” income generally includes:

- Provision of other goods or services with the real estate – for example, a hotel, B&B, etc.;
- Use in an active business operation – for example, office, factory, retail store, warehouse;
- Property that meets the exclusions of “specified investment property”, for example, where more than 5 full time employees are employed by a corporation involved in commercial real estate management or development; and
- Rental of real estate to an “associated” corporation – deemed as active.

Unfortunately this definition can lead to significant differences in how real estate income will be taxed in situations that are not fundamentally different to warrant a different treatment. For example:

- the 5 employee requirement is problematic as it creates a size test that is not relevant, nor can it be met even in a large company if that company chooses to contract out all of its services or hire part time employees rather than employ full time staff, or if it needs to structure its affairs to manage risk (for example – one property per company)
- the same piece of real estate can be classified differently from passive to active or vice versa, with or without changes in ownership of the real estate or whether corporations are “associated” for tax purposes. The TABLE below illustrates some common examples.

TABLE (in all examples, assume less than 5 full time employees)

Type of real estate rental	**Active or Passive**	**Explanation**
Long term residential real estate for investment purposes	Passive	
Residential real estate purchased for employees • But rented to other tenants / not needed for your own employees	Active Passive	Housing needed for staff is used to support your active business No longer used in your active business (if very brief periods of time between housing your own employees you may be able to argue that the 3rd party rental is incidental to the main purpose of providing employee housing, but risky)
Commercial real estate rented to third parties	Passive	
Commercial real estate in one corporation you own (RealCo), rented to another corporation you own (OpCo) • If OpCo sold to third party, you retain RealCo now rent to a third party	Active Passive	Deemed active – associated companies. Allows business owners to segregate their active real estate assets from their active operations without being penalize No longer associated or "deemed active" (in many business transitions, purchaser cannot afford to buy both OpCo and RealCo)
Commercial real estate in corp. owned by 3 equal shareholders (RealCo), rented to another corporation the 3 own (OpCo) • But if 1 shareholder buys out his 2 partners from the OpCo; with all 3 still owing RealCo	Active Passive	Associated, Deemed active, as above The companies are no longer associated as the remaining shareholder in OpCo only owns 1/3 or

		RealCo; therefore, not deemed active.
Commercial real estate in corp. where portion is rented to an associated corp. with the other portion to a third party	Both	Portion rented to associated corp. is “deemed active” Portion rented to third party is “passive” (Note this is an example where an active business has both active & passive real estate and now be subject to SBD grind down)
Corporation has the opportunity to purchase the real estate it leases from landlord, for its own active business but landlord insists that more units or sq.ft. must be purchased than what the corporation needs. Corporation buys all the real estate to secure its operating business with plans to rent out the space that is not needed to third parties	Both	Prorated as above Purchaser is subject to the SBD grind down

From an economic and policy perspective, these situations should not be the determinant of whether real estate is considered to be used in a business. In fact the definition of a business is quite broad and can include any situation where goods and services are or are intended to be exchanged for consideration – a definition that would include property rental. It is time to remove the passive treatment in the ITA to encourage more investment in real estate, to increase supply of both housing stock and commercial real estate, which in turn should improve affordability for both employees and employers and make it easier to attract and retain labour, and to manage the cost of business succession.

Treating net rental income as business income in all circumstances will have the following tax benefits to private corporations:

- Simplify the tax treatment and provide clarity and fairness of how the income will be taxed
- Eliminate the 4% added tax cost of flowing passive income through a corporation
- Eliminate the need to “dividend” out passive income to trigger the “dividend refund”, which is currently necessary to offset the refundable tax and maintain the tax cost at 4%
    - Cash retained can be used for necessary debt servicing or new investments

- Effective for 2019 and future years, avoid a grind down of the small business tax rate where passive income exceeds certain thresholds (currently set at $50,000 based on a notional 5% return on $1,000,000 in assets, with a prorated grind down between $50,000 - $150,000, and a full loss in excess of $150,000)
    - These thresholds are too low and do not reflect the current value of real estate in many Canadian markets or the rental yield they may earn

RECOMMENDATIONS

That the Federal Government:

1. remove net rental income from passive income, making it subject to normal corporate taxation rates for business income

2. Until this change happens, specifically exclude net rental income from investment income subject to the thresholds that grind a private corporation's access to the small business tax rate.

3. If it is necessary to include net rental income as part of the passive investment income subject to the new proposed thresholds, then:
    a. Significantly increase thresholds to reflect economic reality and debt servicing requirements;
    b. Provide exclusions for investments that provide access to affordable residential housing or subsidized employee housing;
    c. Provide exclusions for commercial real estate that is connected to or attached to an operating business, or subject to a business succession plan; and
    d. Provide more appropriate criteria around what is active vs. passive as the "deemed as active" rules are not able to (nor intended to) identify real estate ownership situations and changes in circumstances that should qualify as active

SUBMITTED BY WHISTLER CHAMBER OF COMMERCE

THE TAXATION COMMITTEE SUPPORTS THIS RESOLUTION