Rental Income and Taxes

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Have you been thinking of acquiring a rental property or renting part of your house for income? This article will go through the basics of renting property. For more information, visit the CRA web site and search for rental income.

Rental Income is when you rent property for someone else to use. Property is usually thought of as real estate, but it can be anything that can be rented like a car, snowmobile, power tools, computer and so on. The expectation is that there will be profit because if there is no money being made, there would not be any taxes owing. There would still be a requirement to report activity in most cases, but renting something generally assumes that money will be made over time.

Rental Income Versus Business Income

If you are renting a property only, this would be considered rental income. If you are providing a service that goes along with the property and charging for it, then this would be considered a business. The classic example to show the difference is a Bed and Breakfast. Since there are meals and laundry services that may be provided, this is considered a business as opposed to just having a place to stay on the property and doing your own cooking and cleaning. If there is an existing business and renting a property is a related part of it, then the renting would be considered part of the business. As an example, if you are making auto parts and you lease part of your space temporarily, this renting would be part of your auto parts business rather than rental income.

What Difference Does It Make If Your Activity Is A Business Or Not?

The differences between rental and business income are that rental income transferred to a spouse or child may be attributed back to the person who transferred it whereas income from a business does not have this restriction. This means that whoever paid for the rental property would have to declare the income for tax purposes. If you have children involved in sharing the profit from a rental versus a business, this would mean a difference in who can declare the income and expenses. Rental income is earned where the owner of the property lives, whereas business income is taxed on where the business is located. If you have multiple locations for rental properties or multiple businesses with different tax rates, this may mean a higher or lower tax bill depending on where the businesses are set up. The deductions that are available may differ between rental and business income. There are different rules regarding depreciation of assets or Capital Cost Allowance (CCA) for rental properties as opposed to businesses. Rental income would not subject to CPP deductions but business income would be. A rental property has a calendar year reporting period, but a business can change this to any time during the year. Depending on what your circumstances are, these differences can save you money or create a larger tax bill.

How Do You Report Rental Income?

Rental income is reported on the form T776 -Statement of Rental Income which can be found on the CRA web site. (1)(2) This form would be submitted along with a personal tax return as an additional document. If the renting is part of a business, the form to use is the T2125 - Statement of Business and Professional Activities which is the business form. This would also be added to a personal tax return as an additional document.

Current Expense Versus Capital Expenditure

Both a current expense and a capital expenditure represent money spent during the current tax period. If an expense is occurring to keep the property maintained and in the same working order as before the money was spent, this would be called a current expense. Examples of this are costs that occur day to day for the operation of the rental property – such as utilities, insurance and property taxes. A capital expenditure is money spent on something that is expected to last longer than one year and is either a separate item acquired for the property or an improvement to the property. If the money spent would make the property more valuable or useful compared to otherwise, this would be called a capital expense. An example of a separate item would be an appliance for the kitchen inside the rental property. This appliance is expected to last more than one year, can be moved into another part of the house so it is a separate item, and it is being used by the tenant so it is a viable expenditure for deduction. If there are costs incurred to set up a property or get it available for rent, these costs would be considered capital expenses, and would be part of the acquisition cost rather than separate expenses. The intention behind the money and the state of the property before and after the expense are important in determining how money spent should be treated for tax purposes.

Tax Treatment of Current and Capital Expenses

The major difference between current and capital expenses is the timing of their deduction. The current expense is deducted in the year it occurred in full. A capital expense would be deducted over the life of the asset which usually would mean a period of years. This means that the expense would be deducted more slowly. The spreading of the deduction over multiple years is called depreciation. This is calculated by finding out the class of the item or expense, finding the related depreciation rate and then using that as a partial deduction each year until the expense has been fully accounted for. As an example, if you bought an appliance and it was a Class 8 item, the associated rate of depreciation would be 20% per year. This means that if you buy an appliance that costs $1000, you can deduct 20% of that $1000 or $200 per year.

Depreciation of the Property Itself

Whether to calculate depreciation on the property itself is a choice that is to be made by the taxpayer. There are advantages and disadvantages to claiming this expense. The first factor to keep in mind is that depreciation on the property cannot be used to create a loss on renting the property. If your property is not that profitable, you would not be able to claim much depreciation even if you wanted to. The second factor to keep in mind is that if you claim depreciation, you will likely have to pay more taxes later when you sell the property. Land and buildings do not go down in value very often. When there is a sale, there is usually a capital gain incurred and there will be taxes paid on a fraction of that gain. If you were claiming depreciation along the way before the sale, your tax bill would tend to be higher than otherwise.

Are You Using the Property Personally?

If you are renting something and using it personally at the same time, the rental and personal use portion would have to be divided in some way. This is because anything used for personal reasons would not be deductible or reported on a tax return, but rental property would be. If it is a house being rented, the space would be divided into personal use and rental space, and any expenses would be prorated to reflect how much of the expense should be allocated to the rental property.

The rules discussed in this article are very general and will apply to most rental situations. For more specific situations and further detail, visit the CRA web site.

Sources:

1) http://docs.quicktaxweb.ca/ty10/english/text/en/common/topics/taxline_t4036_rent.html
2) http://www.cra-arc.gc.ca/E/pub/tg/t4036/
3) http://www.ptccanada.com/Booklets/RentalPropertyTaxBooklet.pdf

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