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Deductibility of Building Repair Costs

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Most apartments will require substantial restoration or renovation at some point as they age. A major challenge for building owners is deciding when and which renovations to undertake. In this article, we will provide a brief overview of the tax treatment of these expenditures, as it may have a significant impact on this decision.

Generally, a taxpayer may deduct any reasonable expenses used to earn rental income. However, the timing of the tax deduction differs depending on the classification of the expense. Current expenditures are deductible in the year incurred, whereas capital expenditures are deducted over a number of years based on the "capital cost allowance" provisions.

The distinction between current and capital expenditures, like many other tax matters, is often a matter of interpretation based on the facts surrounding each situation. The term "capital" is not defined in the Income Tax Act (Canada) and is essentially descriptive rather than definitive. Much of the guidance on this matter is provided by the Canada Revenue Agency's (CRA) administrative guidelines and case law, given the subjectivity of the expenditures.

CRA Guidelines

In making the determination between capital and current expenditures, the CRA has adopted the guidelines that have been established by the courts. These guidelines may be used in determining whether an expenditure is capital in nature because property was acquired or improved, or whether it is currently deductible because it is considered to be maintenance or repair. The four main guidelines are as follows:

- 1. Enduring Benefit** - A capital expenditure will bring into existence an asset or advantage for the long-term. A current expenditure would be frequently recurring, such as replacement or renewals, because its useful life will be relatively short-term.
- 2. Maintenance or Betterment** - A capital expenditure materially improves the property beyond its original condition and is clearly of better quality and greater durability. A current expenditure serves only to restore the property to its original condition, using identical or equivalent material.
- 3. Integral Part or Separate Asset** - A capital expenditure introduces a new and separate asset. A current expenditure repairs an integral part of an existing asset.
- 4. Relative Value** - The amount of the expenditure in relation to the value of the property as a whole may also be considered when determining classification. Where the total new expenditure approaches the total value of the property, it will likely be deemed to be of a capital nature. However, relative value may not necessarily be a determining factor. For example, where a major repair is an accumulation of lesser repairs, the expenditures may be classified as current or capital expenditures based on a review of the lesser repairs separately. The fact that the repairs were not done earlier does not change the nature of the work when it is done, regardless of its total cost.

Whether the market value of the property increases as a result of the expenditure is not a factor in determining whether a cost is current or capital; it is simply the nature of the expenditure that is considered.

Court Decisions

A full analysis of the case law is beyond the scope of this article. Although there have been court cases over the past 10 years on this issue, these cases have not provided further clarity. The courts tend to follow the listed guidelines because each case is analyzed on its own facts and certain factors may outweigh others. Therefore, predicting how the courts will rule remains problematic. The courts have, however, put more emphasis on the maintenance or betterment guideline. Therefore, consideration as to whether the expenditure resulted in restoring a building to its original state or creating a lasting improvement is important.

Some examples of capital improvements, as determined by the courts, include: new and improved wiring and lighting, changing floor space, moving bathrooms, wider and better windows and doors, new improved heating, air conditioning and ventilation systems, stoves, refrigerators, sinks, toilets, structural strengthening of the roof, and replacing stucco exterior by an enameled porcelain surface. The classification of these expenditures may differ depending on the specific case facts.

One common issue, particularly in British Columbia, is in respect of the treatment of repairs for leaky condominiums. Expenditures relating to leaky condominiums have not been specifically addressed by the CRA. Any technical interpretations provided by the CRA have referred to, and relied upon, the same guidelines as above. However, it appears that work relating to the exterior walls of a building generally results in a capital treatment. This is based on the assumption that the repair is completed on a different construction strategy to avoid future problems, and therefore involves material improvements. On the other hand, the cost of repairing damage to the internal components of a building requires application of the guidelines discussed above.

As buildings age, their owners will be faced with renovating decisions. When and how those costs are deducted for tax purposes is often not clear-cut and is a matter of interpretation. Before embarking on any major expenditure on your property, consider seeking the advice of a professional accountant on the relevant tax treatment, as the tax deduction of the expenditure in the year or over a number of years may have a significant impact on its feasibility and on cash flow. ⬆

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The information provided is a general overview and should not be construed as tax advice. We recommend seeking professional advice from your tax advisor in respect of your specific situation.