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Looking to Buy Rental Property?
Income Tax Considerations of Personal versus Corporate Ownership

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One of the most common questions that accountants are asked is,
"I am looking to buy a rental property. Should I put it in a company or own it personally?"

The answer to this question will usually be, "It depends."

The Basics

There are many types of entities that can be used to hold real estate, with the two most common structures being personal or corporate ownership. There can also be more complex structures involving partnerships, joint ventures, and bare trustee corporations, which are not discussed in this article.

As accountants, we are often focused on the tax considerations, but there can be legal issues that are equally as important. The following is a high level description of these two types of ownership.

A corporation is a separate legal entity from the shareholders, and any income earned is taxed within the corporation. The after-tax income of the corporation will then be paid to the shareholders as dividends. This means a corporation income tax return and dividend information returns would be filed on an annual basis.

As the corporation is a separate legal entity, it can provide liability protection to the shareholders and allow for flexible ownership and management structures. Legal considerations include shareholder agreements, authority of directors, and contract signing authorities, all of which should be discussed with a lawyer.

The simplest ownership structure is to own real estate personally. Any income is reported directly on the owner's personal income tax return. This minimizes compliance costs compared to a corporation, as there are no extra income tax filings or legal annual reports required.

Income Tax – Personal Ownership

Rental income on property owned personally is reported directly on the personal tax return. The Canadian personal income tax system is considered a graduated system, meaning the tax rates increase as income increases. For 2013, the marginal tax rates in BC range from 20% for income under $37,000 to 43.7% for income above $133,000.

Table 1 – Power of personal marginal income tax rates

	Single Owner	Joint Ownership	
Rental income	$100,000	$ 50,000	$ 50,000
Personal tax	(25,000)	(9,000)	(9,000)
Net after-tax income to owner	$ 75,000	$ 41,000	$ 41,000
Combined after-tax income	$ 75,000	$ 82,000	
Effective tax rate	25%	18%	

Table 1 shows the power of personal marginal rates. This example shows the after-tax income for $100,000 earned by one person compared to the same $100,000 split between two people. After taking the basic personal tax credits into account, there is a $7,000 savings if the $100,000 is split between two people.

Income Tax – Canadian Corporate Ownership

There are different rules for Canadian and foreign-owned corporations. The reason is that Canadian owners ultimately are taxed on their personal tax returns. Therefore, the tax rules for Canadians are integrated; for example, the dividend tax refund rules, which will be discussed below. This article only deals with tax rules for Canadian owned corporations.

Investment income

For most companies, rental income is treated as investment income. For 2013, the corporate tax rate for investment income earned in BC is 45.67%, which is similar to the highest personal marginal tax rate.

The Canadian tax system is designed to be integrated, meaning the total taxes paid, whether the income is earned corporately or personally, should be the same. To achieve this, once the company pays taxable dividends to the shareholders, 26.67% of the corporate tax is refunded to the company. The shareholder also receives a dividend tax credit, which reduces the personal tax rates on dividends.

Table 2 – Effect of integration

Corporate Income Tax			
Rental investment income		$ 100,000	
Corporate tax		(45,667)	
Refundable tax		26,667	
Corporate after-tax income available for distribution		$ 81,000	
Personal Income Tax			
	Single Shareholder	**Two Shareholders**	
Taxable dividend	$ 81,000	$ 40,500	$ 40,500
Personal tax	(9,000)	(1,000)	(1,000)
Net after-tax income to owner	$ 72,000	$ 39,500	$ 39,500
Combined after-tax income	$ 72,000	$ 79,000	
Effective tax rate (personal and corporate)	28%	21%	

Table 2 shows the total taxes for $100,000 of investment income earned in a corporation. As a result of the dividend tax credit, the personal tax income tax rate on dividends is significantly lower than ordinary personal income.

When comparing the total taxes paid for personally-owned property (Table 1) to corporately-owned investment property (Table 2), there is a small tax savings by owning the property personally.

Business income

Corporately-owned rental income is sometimes considered business income. This article does not discuss the details of business income.

To qualify as business income, the company must employ more than five full-time employees in the rental business. For 2013, the corporate tax rate for general active business income earned in BC is 26%. For small businesses, the first $500,000 of income is taxed at only 13.5%.

Summary

The Canadian tax system is designed not to give a tax benefit to corporately-owned investment rental property.

In the case of a single owner with small rental properties, it generally makes economic sense to own the properties personally due to the relative income tax costs and additional compliance costs associated with corporate ownership.

When multiple owners and large properties are involved, then corporate ownership may make sense. Companies can provide flexibility for income splitting and estate planning. often companies will be part of a more complicated ownership structure involving partnerships, joint ventures, and family trusts.

In addition to income tax, there are other legal and operational factors that should be considered when determining whether to own a rental property in a corporation. The determination of the 'right' ownership structure for a real estate investment depends entirely on the specific situation.

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.

Alex Wong is a senior manager in the Real Estate and Construction Group at Smythe Ratcliffe LLP. Smythe Ratcliffe LLP is a proud member of RHC, and is one of the leaders in accounting and tax advisory services in the real estate and construction industries in BC. Our experience with real estate owners, investors, and construction companies allows us to tailor our services to our client's specific needs. For further information, contact us at 604.687.1231 or visit our website at www.smytheratcliffe.com.